

THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

HEARING BEFORE THE SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS OF THE COMMITTEE ON COMMERCE HOUSE OF REPRESENTATIVES ONE HUNDRED SIXTH CONGRESS SECOND SESSION

ON

H.R. 454

JULY 12, 2000

Serial No. 106-123

Printed for the use of the Committee on Commerce



U.S. GOVERNMENT PRINTING OFFICE

65-907CC

WASHINGTON : 2000

COMMITTEE ON COMMERCE

TOM BLILEY, Virginia, *Chairman*

W.J. "BILLY" TAUZIN, Louisiana	JOHN D. DINGELL, Michigan
MICHAEL G. OXLEY, Ohio	HENRY A. WAXMAN, California
MICHAEL BILIRAKIS, Florida	EDWARD J. MARKEY, Massachusetts
JOE BARTON, Texas	RALPH M. HALL, Texas
FRED UPTON, Michigan	RICK BOUCHER, Virginia
CLIFF STEARNS, Florida	EDOLPHUS TOWNS, New York
PAUL E. GILLMOR, Ohio	FRANK PALLONE, Jr., New Jersey
<i>Vice Chairman</i>	SHERROD BROWN, Ohio
JAMES C. GREENWOOD, Pennsylvania	BART GORDON, Tennessee
CHRISTOPHER COX, California	PETER DEUTSCH, Florida
NATHAN DEAL, Georgia	BOBBY L. RUSH, Illinois
STEVE LARGENT, Oklahoma	ANNA G. ESHOO, California
RICHARD BURR, North Carolina	RON KLINK, Pennsylvania
BRIAN P. BILBRAY, California	BART STUPAK, Michigan
ED WHITFIELD, Kentucky	ELIOT L. ENGEL, New York
GREG GANSKE, Iowa	TOM SAWYER, Ohio
CHARLIE NORWOOD, Georgia	ALBERT R. WYNN, Maryland
TOM A. COBURN, Oklahoma	GENE GREEN, Texas
RICK LAZIO, New York	KAREN MCCARTHY, Missouri
BARBARA CUBIN, Wyoming	TED STRICKLAND, Ohio
JAMES E. ROGAN, California	DIANA DEGETTE, Colorado
JOHN SHIMKUS, Illinois	THOMAS M. BARRETT, Wisconsin
HEATHER WILSON, New Mexico	BILL LUTHER, Minnesota
JOHN B. SHADEGG, Arizona	LOIS CAPPS, California
CHARLES W. "CHIP" PICKERING, Mississippi	
VITO FOSSELLA, New York	
ROY BLUNT, Missouri	
ED BRYANT, Tennessee	
ROBERT L. EHRLICH, Jr., Maryland	

JAMES E. DERDERIAN, *Chief of Staff*

JAMES D. BARNETTE, *General Counsel*

REID P.F. STUNTZ, *Minority Staff Director and Chief Counsel*

SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS

MICHAEL G. OXLEY, Ohio, *Chairman*

W.J. "BILLY" TAUZIN, Louisiana	EDOLPHUS TOWNS, New York
<i>Vice Chairman</i>	PETER DEUTSCH, Florida
PAUL E. GILLMOR, Ohio	BART STUPAK, Michigan
JAMES C. GREENWOOD, Pennsylvania	ELIOT L. ENGEL, New York
CHRISTOPHER COX, California	DIANA DEGETTE, Colorado
STEVE LARGENT, Oklahoma	THOMAS M. BARRETT, Wisconsin
BRIAN P. BILBRAY, California	BILL LUTHER, Minnesota
GREG GANSKE, Iowa	LOIS CAPPS, California
RICK LAZIO, New York	EDWARD J. MARKEY, Massachusetts
JOHN SHIMKUS, Illinois	RALPH M. HALL, Texas
HEATHER WILSON, New Mexico	FRANK PALLONE, Jr., New Jersey
JOHN B. SHADEGG, Arizona	BOBBY L. RUSH, Illinois
VITO FOSSELLA, New York	JOHN D. DINGELL, Michigan,
ROY BLUNT, Missouri	(Ex Officio)
ROBERT L. EHRLICH, Jr., Maryland	
TOM BLILEY, Virginia,	
(Ex Officio)	

(II)

CONTENTS

	Page
Testimony of:	
Levitt, Hon. Arthur, Chairman, Securities and Exchange Commission	21
Parkinson, Patrick M., Associate Director, Division of Research and Statistics, Board of Governors, Federal Reserve System	43
Paul, C. Robert, General Counsel, Commodity Futures Trading Commission	39
Sachs, Lewis A., Assistant Secretary for Financial Markets, Department of the Treasury	47
Material submitted for the record by:	
Bond Market Association, prepared statement of	61
Chicago Board of Trade, prepared statement of	56
Gordon, Scott, Chairman, Board of Directors, Chicago Mercantile Exchange, prepared statement of	58
Parkinson, Patrick M., Associate Director, Division of Research and Statistics, Board of Governors, Federal Reserve System, letter dated July 19, 2000, to Hon. Tom Bliley, enclosing response for the record	64
Sachs, Lewis A., Assistant Secretary for Financial Markets, Department of the Treasury, letter dated August 8, 2000, to Hon. Thomas J. Bliley, enclosing response for the record	66
Skolnik, Barry W., President, North American Securities Administrators Association, letter dated July 12, 2000, providing comments for the record	60

(III)

THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

WEDNESDAY, JULY 12, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Cox, Largent, Ganske, Shimkus, Wilson, Fossella, Ehrlich, Bliley (ex officio), Towns, Stupak, Barrett, Luther, Markey, Rush, and Dingell (ex officio).

Also present: Representative Ewing.

Staff present: David Cavicke, majority counsel; Brian McCullough, majority professional staff; Shannon Vildostigui, majority professional staff; Robert Simison, legislative clerk; and Consuela Washington, minority counsel.

Mr. OXLEY. The subcommittee will come to order.

Before my opening statement, I would like to recognize the gentleman from Illinois, Mr. Ewing, a refugee from the Agriculture Committee, who has been kind enough to sit in on our hearing since this is the legislation that he authored in the Agriculture Committee and he Chairs the subcommittee of jurisdiction there. Tom, welcome.

This subcommittee has dealt with many complex financial issues over the years with a great deal of success. Last fall financial modernization was enacted into law after years of attempts to bring meaning to an evolving financial services marketplace. Orders and rules were established for the blurring lines between insurance, securities and banking. Our financial markets are not the best in the world because they stand still. Instead constant developments and new products derived from competition emerge to fill the needs of customers.

Our financial markets have long since passed a time when their role was limited to the purchase and sale of securities and futures for investment purposes. Increasing need to minimize exposure to fluctuating interest rates and uncertain financial markets provided the impetus for valuable risk management tools such as financial futures and other financial derivatives. This evolution has led to futures on broad stock indices, and more recently narrow baskets of stocks.

As with the financial services legislation, new products that begin to look alike can cause regulatory and legal confusion. H.R.

4541, the Commodity Futures Modernization Act of 2000, contains several provisions that seek to eliminate confusion and create a defined regulatory structure. Most people are unaware of how important the derivative market is for our economy. The amounts involved are staggering, with trillions of dollars of contracts trading annually. These are valuable products that should not be jeopardized with legal uncertainty. Because they rely on a regulatory exemption from the Commodity Exchange Act, they are subject to changes or interpretations by future regulators. If we are agreed that the policy of allowing this flourishing market to continue without being subject to the CEA, then we need to codify it in legislation and eliminate that uncertainty. H.R. 4541 addresses this problem in a fashion similar to the recommendations outlined in the President's Working Group report.

I am interested to hear the comments of our witnesses about these provisions and further discussion regarding the legal uncertainty. Equally important is the repeal of the Shad-Johnson Accord, which prohibits single-stock futures. Until now these products were banned because an agreement on the regulatory regime between the SEC and CFTC was never reached since the ban was implemented in 1982. The President's Working Group on Financial Markets agreed last fall that the prohibition could be repealed if certain regulatory issues and the concerns about the integrity of the underlying equity markets were addressed properly. I know disagreements remain between the agencies on this provision as reported, but failure to reach agreement now between the SEC and the CFTC is simply not an option. We have waited 18 years for the temporary ban to be lifted on a potentially useful financial product. If we wait any longer, the activity will move offshore, and I am confident agreement can be reached.

Requests were made of the SEC and the CFTC to work together to find a compromise solution. I would request that each of these agencies provide this subcommittee in writing with the status of the negotiations to detail the specifics of what has been agreed to and what remains unresolved. I look forward to the comments of our witnesses and any suggestions they have for their suggestions on improvements to the legislation. We have a distinguished group of witnesses today and we look forward to hearing from them.

It is now my pleasure to recognize the gentleman from New York, Mr. Towns, the ranking member.

Mr. TOWNS. Thank you, Mr. Chairman. I also thank you very much for holding this hearing on this very important bill.

It is unfortunate that the committee has been given such a short time to deal with this bill because it raises issues that go to the heart of this committee's jurisdiction. However, I hope that we could work together to craft a good bill in the short time given to us. As it has been described, the bill coming over to our committee from the Agriculture Committee has three titles. Title I deals with the legal certainty for the over-the-counter derivative transactions. Title II provides regulatory relief to the U.S. Futures exchanges. Title III attempts to address Shad-Johnson and the trading of single-stock futures.

I would like to focus my remarks on title I and III of the bill. Title I of the bill is critically important to U.S. investment in com-

mercial banks and U.S. companies that use OTC derivatives to manage risk. This title establishes the necessary legal certainty for these OTC derivatives transactions. Specifically, the title insures that no court or regulator can make a determination that could invalidate billions of dollars of legitimate derivative contracts. This uncertainty is a cloud hanging over numerous types of transactions, such as OTC transactions, government securities and other financial instruments. U.S. financial markets should not be forced to tolerate the risk of such legal uncertainty.

Mr. Chairman, this is extremely important. However, let me add we have what I see as a unique opportunity before us. As I understand it, the language coming out of the Agriculture Committee addressing legal certainty is strongly supported by the major financial trade associations, the major U.S. investment and commercial banks, United States futures exchanges, all four members of the President's Working Group. I find this unanimity of agreement to be almost unprecedented. We should seize this moment. Recognizing that no bill or title is perfect, there are obvious issues that need to be resolved in title III. However, with title I receiving this kind of broad support, it appears evident that we need to act on this legislation and at a minimum provide OTC derivative transactions with the necessary legal certainty.

I do want to express my concerns about the portions of the Commodity Futures Modernization Act of 2000 dealing with single-stock futures. The bill would permit the trading of the single-stock futures without the regulatory requirements imposed on securities. Stock futures will act as a direct surrogate for individual stocks and will be marketed to retail investors across this country. The SEC is the expert regulator charged with oversight of the securities markets. It is critical that the SEC be able to administer the security markets provisions it feels are necessary for stock futures.

The bill also would provide stock futures with regulatory advantages over competing securities products such as stock and stock options. Customers of single-stock futures would be exempt from Federal transaction fees imposed on securities and be subject to different margin levels than for stock options. This is unfair and should be remedied, and we must find a way to do that.

For these reasons I believe that the stock futures provision of the Commodity Futures Modernization Act should be modified to address the legitimate concerns of the SEC and securities markets regarding the regulatory and competitive disparities between futures and securities arising from single-stock futures. If this cannot be accomplished, if this cannot be accomplished, I repeat, within the short time remaining in this congressional session, then the stock futures provision should be removed from the bill so that Congress can act on the important legal certainty provisions in the bill. I strongly feel that under no circumstances should we delay a legal certainty provision.

On that note, Mr. Chairman, I yield back the balance of my time. I am anxious to hear the comments coming from our witnesses.

Mr. OXLEY. I thank the gentleman. The Chair now recognizes the chairman of the full Commerce Committee, the gentleman from Richmond, Mr. Bliley.

Chairman BLILEY. Thank you, Mr. Chairman. Since 1982, when the SEC and the CFTC could not agree on who was to regulate single-stock futures, they agreed to ban the product. Although the ban was never intended to be permanent, they have yet to reach agreement on who should regulate them. Only in Washington do we ban something when we can't figure out who regulates it.

Last November, to assist Congress on issues addressing the commodities markets, the President's Working Group on Financial Markets issued a report and it detailed changes that should be made in order that regulation keep pace with the rapidly evolving marketplace. Among the suggested changes was the repeal of the ban on single-stock futures. The President's Working Group agreed that the ban on single-stock futures could be repealed provided issues of regulatory structure and integrity of the underlying cash markets could be resolved.

On the basis of this report I, along with Chairman Larry Combest and Chairman Tom Ewing, wrote to the SEC and the CFTC asking them to resolve this dispute. The response from the two agencies was troubling, as they were once again unable to reach any substantial agreement. Although single-stock futures may very well turn out to be much fuss about little, their prohibition is based on little more than an old-fashioned turf war. This is at odds with the principles of capitalism and freedom. If the agencies cannot resolve this dispute, Congress will have to do it for them.

The President's Working Group also stressed the importance of providing greater legal certainty to over-the-counter derivatives. Trillion dollar products are currently traded in reliance on a CFTC exemption and a prayer that a court will not find the contract to be a future. Systematic risk may exist so long as these products trade without adequate legal certainty. That is precisely why the President's Working Group strongly urges certainty in this area. We need to make sure that those investing in our markets have confidence that the products in which they are trading are legally binding. Doing so will continue the viability of the American market for these products.

Mr. Chairman, under your leadership, this subcommittee has worked hard to ensure our financial markets are the envy of the world. This bill before us today reflects a good starting point for this committee to continue its work of shaping a framework which will allow our markets to grow with a certainty that our investors have come to expect. We don't have a lot of time to consider this important legislation, but we will do our best.

I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back. The Chair is now pleased to recognize the gentleman from Michigan, the ranking member of the full committee, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I thank you for recognizing me and I commend you for holding this important hearing, and I warmly welcome our distinguished witnesses, especially our friend, the Chairman of the SEC.

Mr. Chairman, I would begin by observing that this committee has jurisdiction over the securities industry, and the securities markets of this country. I note to you in the exercise of that jurisdiction, we have had a remarkable success going back to the origi-

nal 1933 and 1934 acts, and that the success of this has been to see to it that our markets are the most trusted and respected in the world, which is why everybody comes over here to invest in the American securities industry.

I would note, however, that the same successes have not occurred with regard to the futures markets, which at different times take on the appearances and some of the characteristics of cesspools. The protections which one would observe for the American securities markets are very clear. There are paper trails, protections against fraud and, in addition to that, strong prohibitions against insider trading. A market which has been disciplined by this kind of oversight by the SEC and the kind of oversight that was crafted by this committee in 1933 and 1934 has brought remarkable success and extraordinary trust.

As I have observed, the securities market everybody thinks runs on money. It does not. It runs on public trust, and if the trust is there, people make lots of money and that is people inside and outside of the market.

I would like now to be blunt. This committee has jurisdiction of the securities industry. And while the Agriculture Committee may have jurisdiction over the futures market, I should say that they should exercise that with more diligence than they have done so in the past. I intend to see that this committee exercises its jurisdiction over the securities market to protect the American investors and to see to it that the integrity of that market system is carried forward and protected.

I would ask to be forgiven for being blunt. This bill is a real turkey, and most of you know that I am a turkey hunter. If the bill's many defects are not fixed in this committee, I will do everything within my power to put this legislation out of its misery at the earliest opportunity.

First, I support the effort to provide legal certainty for the OTC derivatives. The Commerce Committee played an instrumental role in crafting and passing the swaps exemption in the 1992 Futures Trading Practices Act. I would like to be in a position to support the legal certainty provisions of H.R. 4541. However, the bill before us contains defective provisions on the regulation of clearinghouses that must be fixed to assure appropriate regulation of the risks that may be concentrated there. I am also concerned that the bill's definition of eligible contract participants includes retail investors who have no business in these unregulated institutional markets.

I have other questions and concerns about this part of the bill, but these are the principal ones.

Second, my general disdain for the quality of futures regulation in this country has not improved after reading this bill. As I understand it, H.R. 4541 transforms the CFTC from a "front line regulatory agency" into an "oversight regulator" of what the bill calls "acceptable business practices under core principles" that will be applicable to registered futures markets. I am still waiting to see something that would fill that definition. If the CFTC believes that a registered entity is violating these yet to be determined core principles, it must first notify the entity in writing, then recommend an appropriate remedial action to remove the deficiency, but only after first conducting a cost-benefit analysis of the remedial action;

and finally, the burden of proof is shifted to the CFTC, which must demonstrate the violation by a preponderance of the evidence.

Now it would go to several things. First of all, when events happen in the futures market, they happen very fast because it is a very volatile market, and the ability to respond to a major scam or serious misbehavior under these circumstances is virtually nonexistent. Certainly it is not possible under any expectation that it might occur in a timely fashion. I am sure that every crook and swindler in the country is hoping that these outrageous provisions stay in the bill. I support reasonable regulatory relief for the futures exchanges, but H.R. 4541 is clearly contrary to the public interest.

Third, and I have saved the best for last, I see absolutely no redeeming value whatsoever in the provisions of this bill that would lift the ban against single-stock futures and create a defective regulatory structure for these retail products under the Commodity Exchange Act and the CFTC, the same CFTC that this bill reduces to a defanged oversight regulator of core principles.

This part of the bill, section 8, futures on securities, poses a serious threat to the integrity of the country's capital markets and undercuts over 6 decades of unparalleled investor protection and investor confidence and makes a joke of fair competition between the markets. These provisions are opposed by anybody who knows anything about securities. The Securities and Exchange Commission, the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, the Nasdaq Stock Market, the New York Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, the Depository Trust and Clearing Corporation, and the Options Clearing Corporation, among others.

Mr. Chairman, I ask unanimous consent to include in the record a May 22, 2000 Business Week article entitled "The Case Against Single-stock Futures" as well as copies of the June 27, 2000 letter of the New York Stock Exchange and the July 11, 2000 memorandum of the United States Securities Markets Coalition setting forth these entities' detailed concerns with this bill.

Mr. OXLEY. Without objection, so ordered.

[The article follows:]

[Business Week—May 22, 2000]

THE CASE AGAINST SINGLE-STOCK FUTURES

Commentary By Joseph Weber

As if trading stocks wasn't wild enough these days, the folks at the Chicago Mercantile Exchange and the Chicago Board of Trade want to give investors a chance to take a real roller-coaster ride. Exchange officials are teaming up with friendly legislators in Congress to revive an idea that some regulators in Washington thought they had buried 18 years ago—futures contracts on individual stocks. "We have all the necessary safeguards in place to be able to trade single-stock futures, and we see no reason why we shouldn't be able to," argues Scott Gordon, chairman of the board of the Chicago Merc. "The public interest would be served."

And that may be so. But in fact, a strong argument can be made that single-stock futures are a financial vehicle whose time has most definitely not come. While they surely would be useful to institutional investors and a handful of speculators, they pose a risk to small investors—and may even encourage stock manipulation.

To be sure, futures contracts have an honored place in the panoply of financial instruments. They can be found for everything from Treasury bonds to pork bellies. They are widely used as hedges against adverse price moves and are also popular

speculations. In theory, both speculators and hedgers could make good use of single-stock futures. By selling futures contracts, money managers could hedge their portfolios against stock drops. By buying them, they could bet on stock-price rises when they don't want to—or can't—commit immediately to the purchase of certain stocks.

True, you can do this already with options. But a futures contract would be cheaper than an option because it wouldn't include a premium, as an option does. "We want the widest possible array of choices," says William P. Miller II, a Chicago Mercantile Exchange director who chairs the End Users of Derivatives Council for the 12,000-member Association for Financial Professionals.

But that cheapness comes at a cost. For one thing, the futures market is a veritable lion's den of risk, particularly for small investors, who can put up just modest amounts of money and either win or, more often, lose big. If investors bet wrong with options, their loss is capped at the premium they paid to buy them; with futures, the potential loss is open-ended. To play the futures market, an investor need put up as little as 5% of the value of a common futures contract—vs. the 50% margin required for stocks. What's more, futures players don't have the same regulatory protections that investors in the stock market take for granted, such as comparable insider-trading rules. There is no prohibition of insider trading in the Commodity Exchange Act.

And fears abound that the high leverage connected with futures could tempt would-be stock manipulators. An April report on single-stock futures by the General Accounting Office warns that "even a small price movement in the underlying stock could encourage attempts to manipulate stock prices." Ordinarily, futures contracts are far more volatile than the spot prices of the underlying securities. Thus, a scamster could make large sums of money in futures by engineering even small moves in the underlying stock. What's more, there's a potential feedback loop: If they became popular, the futures "could spawn great volatility in stocks," warns Bruce I. Jacobs, a portfolio manager at Jacobs Levy Equity Management who has written a book about derivatives and stock market crashes.

Because such issues have never been resolved, futures on single stocks have been in limbo for nearly two decades. In 1981, the Securities & Exchange Commission and the Commodity Futures Trading Commission promised to study all the issues surrounding the idea. Meanwhile, they imposed a "temporary" ban. Now, the idea has reared its head again.

And it has a real chance at success because of domestic and foreign competitive concerns, such as the emergence of single-stock futures abroad and similar investment devices in the U.S., as well as the growth of electronic-trading technology, and a good old-fashioned wish to end regulation. "We do have the stars aligned," says Senator Phil Gramm (R-Tex.), chairman of the Senate Banking Committee, who held a hearing on the Shad-Johnson Accord and markets regulation on May 8 in Chicago. Gramm and Senate Agriculture Committee Chairman Richard G. Lugar (R-Ind.) plan to introduce a bill to legalize stock futures. They may tie the move to reauthorization of the Commodity Exchange Act, which empowers the CFTC, and which expires on Sept. 30.

Regulators have given the idea a mixed response. SEC Chairman Arthur Levitt Jr. and CFTC Chairman William J. Rainer are still haggling over just how the new products would be overseen. Rival markets are hardly enthusiastic. And no wonder—futures could pose a competitive threat. The head of the Merc's archival in the Loop, William J. Brodsky of the Chicago Board Options Exchange, says single-stock futures must be treated the same as stocks—with the same aggressive SEC oversight and stiffer margin requirements—or they "would worsen the competitive inequities" among exchanges. CFTC Chief Rainer says the required margin would be somewhere between the 50% minimum required for stocks and the 5% to 10% generally required for commodity futures contracts.

Single-stock futures face an even more fundamental question: Is Congress rushing to approve a product of limited appeal? The answer to that may well be yes. Single-stock futures are already offered on about nine European and Asian exchanges—and they've proved to be anything but barnburners. They account for less than 1% of the total trading volume of the foreign futures markets. "The anecdotal evidence is that the marketplace doesn't want these things," adds Robert E. Whaley, a professor of finance at Duke University's J.B. Fuqua School of Business. Similar products are already available in the U.S., but they, too, command fairly small followings. On the over-the-counter market, for instance, financial professionals can buy equity swaps. But these account for only a fraction of the value of OTC derivatives trading, says the GAO.

Certainly, single-stock futures contracts will be easier to understand than these jury-rigged instruments. And that could raise a problem: They would also be simpler to market to unsophisticated investors, who usually wind up behind the eight ball

when they trade futures. “The vast majority of small investors in futures trading—commodity futures—ultimately come out losing money,” warns John F. Marshall, a professor of finance at St. John’s University. It is, in his view, “a zero-sum game.”

Zero-sum or not, this new game has powerful friends on Capitol Hill, and that alone means that single-stock futures may well be on the horizon. If they do not turn out to be a flop, as they were overseas, their potential for abuse could make them a risky innovation. Small investors may pay the price for the Street’s latest big idea.

NEW YORK STOCK EXCHANGE
June 27, 2000

The Honorable TOM BLILEY
Chairman
Committee on Commerce
2125 Rayburn House Office Building
Washington, DC 20515

DEAR MR. CHAIRMAN: I am writing to share the views of the New York Stock Exchange, Inc. (NYSE) on H.R. 4541, the Commodities Futures Modernization Act of 2000. The NYSE is interested in two aspects of this important legislation—repeal of the Shad-Johnson Accord and legal certainty for equity swaps. While we commend Chairman Tom Ewing of the Risk Management Subcommittee of the House Agriculture Committee for his tireless efforts with regard to Commodity Futures Trading Commission (CFTC) reauthorization, we are compelled to oppose H.R. 4541, as reported by the Agriculture Committee.

Single Stock Futures

The NYSE agrees with the President’s Working Group on Financial Markets that the “current prohibition on single stock futures can be repealed **if** issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved.” *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, page 32 (1999)(emphasis added). Unfortunately, H.R. 4541 does not adequately address the issues raised by the Working Group.

For the last six months, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), the two agencies with the expertise to address this complex issue, have been working diligently to develop a joint regulatory framework applicable to single stock futures. Much progress has been made. However, difficult issues remain to be resolved.

It is vital that regulatory issues relating to the SEC’s ability to adequately enforce the insider trading and other anti-fraud laws, and to protect retail investors be resolved properly in the first instance. If the right balance is not struck, single stock futures entail a high risk of great harm to retail investors and confidence in the U.S. securities markets. The United States stock market is unique in the world because of its enormous size and its high level of individual investor protection. Today, more than 70 million Americans participate in the stock market. Individuals and institutions are willing to invest in the U.S. stock market because they believe in the integrity of the market. Investor confidence is fragile. Once lost, it can be extremely difficult to regain.

H.R. 4541’s approach to single stock futures falls short in a number of important areas. The SEC’s authority to enforce securities laws regarding insider trading, manipulation and fraud is too circumscribed and would leave the SEC unable to fully protect retail investors and market integrity.

Further, the SEC must have the authority to inspect the surveillance programs of futures exchanges that trade single stock futures because without direct access to audit trail, coordinated market surveillance and inspection authority, the grant of enforcement authority to the SEC is illusory. The SEC does not have the resources to detect and deter insider trading and other violations of the securities laws alone. It depends on the surveillance programs of self-regulatory organizations (SROs), i.e., the securities markets, to augment its efforts. The SEC regularly inspects the surveillance programs of the SROs to ensure that they are adequate. The SEC must have the same authority with regard to futures exchange surveillance programs applicable to single stock futures.

H.R. 4541 also provides that the SEC can obtain information from futures exchanges only with the permission of the CFTC. This subordinate role for the SEC is unacceptable. To fully discharge its responsibilities under H.R. 4541, the SEC must have the unfettered ability to obtain the information that it needs.

H.R. 4541 requires that margin levels for single stock futures be consistent with the margin on comparable options listed on a securities exchange. Further work to

harmonize margins needs to be done. In determining whether margins are consistent, all rules governing margin, including the penalties for violating margin rules, must be consistent. H.R. 4541 would permit the Federal Reserve Board to delegate its margin oversight authority to the CFTC alone. In the NYSE's view, the Fed should delegate its margin authority, not to the CFTC, but to the Intermarket Margin Board described in H.R. 4541. This Board would consist of the Fed, SEC and CFTC. Otherwise, margins on single stock futures, even if consistent at the outset, will not remain consistent with margins on stock options over time.

H.R. 4541's recognition that a suitability rule must apply to single stock futures is positive. However, the bill should mandate that such a suitability rule should be at least as stringent as suitability rules applicable to stock options. Also, the fact that suitability is a continuing requirement over the life of an account needs to be clarified.

Finally, the provisions of H.R. 4541 are anti-competitive. H.R. 4541 provides that single stock futures can only be traded on a futures exchange. Securities exchanges should have the ability to trade this product as well. H.R. 4541 also fails to extend the Section 31 transaction fee to single stock futures. This fee is applied to all stock and stock options sales. Single stock futures will be direct substitutes for these products. Competitive fairness requires that single stock futures also be subject to this transaction fee.

Legal Certainty for Equity Swaps

The NYSE's interest in legal certainty for over-the-counter derivatives is limited to equity swaps based on single stocks and narrow-based indexes. The NYSE is concerned about the legal status of these products because they are so closely linked to our own market.

The NYSE supports legal certainty for equity swaps. However, we believe that exclusion from the CEA for equity swaps needs to be coupled with Congressional recognition that this type of OTC derivative is a security. Only by making it clear that equity swaps are subject, at least, to certain investor protection provisions of the securities laws can Congress and regulators assure that such products will not be used to circumvent the insider trading, fraud and manipulation prohibitions of those laws. It is also important that the proper margin, capital and sales practice standards apply to these instruments, and that they be integrated into the surveillance systems currently applicable to equities and all other equity-based derivatives. H.R. 4541 fails to clarify that equity swaps are securities. Without this clarification, we are concerned that the equity swap market may develop only for regulatory arbitrage, not to meet the legitimate risk management needs of investors.

The President's Working Group recommended that an exclusion from the CEA for OTC derivatives should only cover swaps between eligible swaps participants. The Working Group agreed that consideration should be given to restricting the extent to which individuals qualify for the exclusion by not making it available to natural persons who own and invest, on a discretionary basis, less than \$25 million in investments. H.R. 4541 defines eligible participant to include individuals with \$10 million in total assets. This threshold would encompass a large number of individual investors, and make it all the more pressing for Congress to clarify that excluded equity swaps are securities. Without such clarification, these individual investors would not have the benefit of the customer protections that all other individual investors in securities currently enjoy.

Thank you for considering the NYSE's concerns about H.R. 4541. We look forward to working with you and the Committee to address these issues.

Sincerely yours,

RICHARD A. GRASSO
Chairman and Chief Executive Officer

cc: Congressman John Dingell
Congressman Mike Oxley
Congressman Ed Towns

MEMORANDUM

TO: David Cavicke, Consuela Washington
FROM: The U.S. Securities Markets Coalition
RE: H.R. 4541 and Stock Futures
DATE: July 11, 2000

This memo serves to provide comment from the U.S. Securities Markets Coalition¹ on H.R. 4541, particularly those aspects of the bill that would permit the trading of stock futures.

Stock futures will act as surrogates for stocks and stock options. They will trade on public marketplaces, be marketed to retail investors, become part of the price discovery process for stocks and derivatives based on stocks, and, unfortunately, be used in schemes perpetrated by stock manipulators and scamsters. We therefore find it quite unsettling that H.R. 4541, for the most part, rejects the notion of applying the securities laws framework to these products. Instead, it applies the commodities laws to these products and charges the CFTC to oversee them. The commodities laws are not designed to address retail trading of a stock-based product. Moreover, the CFTC, whose role in supervising the futures markets will be greatly reduced if H.R. 4541 were passed, has little experience in retail stock-based financial product regulation. While the bill provides the SEC certain limited authority to apply a handful of securities laws to stock futures, a number of important statutory protections have been omitted. Moreover, SEC authority would be limited to mere "enforcement" authority. It would not, for example, have authority to conduct oversight examinations of futures exchanges or exercise its rulemaking authority to adopt standards that would deter fraud and manipulation.

As acknowledged by the President's Working Group, the issue of how to regulate stock futures presents not only market integrity issues but also important regulatory arbitrage issues. Some of these arbitrage issues relate primarily to core investor protection concerns, such as how to address insider trading issues. Other issues, arising from the similarity between stock futures, stock, and stock options, relate primarily to fair competition concerns. Most of the issues involve a combination of both concerns.

We remain stalwart in our view that the most effective and fairest approach is to treat stock futures as securities. It is the only way to ensure that the panoply of securities laws protections apply to a product that is security in all but technical name.² It is also the only way to ensure that the regulation of stock futures is consistent with the regulation of stocks and stock options. As a next best alternative, we believe some form of joint SEC/CFTC regulation of stock futures could be possible, provided stock futures are treated as securities but are exempted from securities regulations where commodities regulation better serves the investing public. The approach of the Ewing bill, to define stock futures as futures, then engraft several securities laws provisions onto the futures regulatory scheme, is the least favored approach, and the one that presents the greatest erosion of investor and market protections. It is also the approach that produces the greatest potential for competitive inequalities between futures and securities. We have identified below certain essential fixes to the most glaring deficiencies of the Ewing bill. Our points follow:

- Stock futures, including those that settle in stock, should be allowed to trade on securities exchanges. The Ewing bill restricts the trading of stock futures to futures exchanges. S. 2697, by comparison, allows cash-settled stock futures to trade both on futures exchanges and securities exchanges. The CFTC did not object to the provisions of S. 2697 that would allow stock futures to trade on securities exchanges. Allowing stock futures to trade on securities exchanges can be accomplished by defining stock futures as securities under the securities laws and deleting the exclusive jurisdiction provisions of the CEA. The exclusive jurisdiction provisions of the CEA are anticompetitive. In addition to creating legal certainty problems for swaps, these provisions have allowed the CFTC and futures exchanges to block securities exchanges from offering a number of securities derivatives products, including certain securities hybrids and index participations. At the very least, however, any compromise that allows stock futures to trade on other than a securities exchange should allow this "new" product to trade both on securities and futures markets.

¹The members of the U.S. Securities Markets Coalition are the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, The Depository Trust Clearing Corporation, the National Association of Securities Dealers, the Pacific Exchange, the Philadelphia Stock Exchange, and The Options Clearing Corporation.

²Most of the attention in this controversy has been focused upon the regulation of trading stock futures. Regulation of those that give investment advice with respect to stock futures and the regulation of managed pools of stock futures outside of the established securities framework raise a host of additional investor protection and competitive issues that have yet to be fully considered.

- If stock futures are permitted to trade under the CEA, then securities exchanges should be allowed to trade futures on all financial instruments. The current bill represents the futures exchanges' view of how stock futures should be allowed to trade—subject to a monopoly on their markets. If Congress is going to consider scrapping traditional jurisdictional boundaries for financial products, fairness dictates that the securities exchanges be provided with an adequate opportunity to make the case for being able to trade financial futures. This is also consistent with Congressman Ewing's stated view that H.R. 4541 should reflect a comprehensive regulatory reform package.
- Margin treatment must be "truly" equal between securities (particularly options) and futures markets. The Ewing bill, notwithstanding its basic call for "consistent" margin levels between stock futures and stock options, does not create a mechanism that will ensure this result. The Ewing bill would provide a tremendous amount of leeway and ambiguity in determining stock futures margin levels. Its standards for consistent treatment are too loose and would allow separate regulators to arrive at significantly different margin levels. For example, the CFTC would be able to decide stock futures margin levels and the SEC would determine stock option margin levels. How can equal treatment be assured where separate regulators are applying an elastic standard? Even if the margin board (Fed, SEC, and CFTC) were used as permitted, the Fed, in turn, would be able to delegate the ultimate setting of margin levels back to the CFTC and SEC, respectively. The bill also does not contain a legislative mandate for the Fed to ensure that the margin levels across securities and futures markets are equal from a competitive perspective. Nor does the bill address important margin issues apart from margin levels, including who customer margin levels should apply to, permitted margin offsets, and acceptable forms of collateral. For these reasons, we believe either the SEC or the Fed should singly determine margin policy for stock, stock options, and stock futures. If an inter-market margin board is used, once the board arrives at a margin policy it should be the responsibility of the SEC to oversee and administer its implementation across all markets.
- Stock futures must be subject to a sales practice program that is equivalent with that which applies to stock options. The Ewing bill only requires the NFA to adopt a suitability rule that is similar to the suitability rule currently applied to exchange-listed options. Merely adopting such a rule does not ensure that stock futures sales practices will be adequate, much less comparable to the high standards established by the securities markets. For example, as you know, the NASD administers a comprehensive sales practice program that applies to stocks and stock options. Also, related issues such as disclosure (i.e., equivalent of an Options Disclosure) and product advertising must be addressed. The SEC should be provided broad rulemaking authority for sales practices across all public markets for stock, stock options and stock futures products.
- The legislation must mandate a regulatory framework that will ensure futures exchanges trading stock futures adequately surveil their markets for market abuses and share such information with other futures and securities exchanges. Given that stock futures transactions will directly impact stock pricing and likely be used as part of stock fraud and stock manipulation strategies, the SEC should be given authority to oversee the market surveillance programs of stock futures markets. Related to this point, stock futures markets should be required to maintain a real-time consolidated audit trail. While an audit trail requirement is contained in S. 2697, it is not made subject to SEC oversight and rulemaking. Congress should define the basic principles of such an audit trail and provide the SEC with authority to oversee its operation.
- Full anti-fraud anti-manipulation authority of federal securities laws should apply to stock futures. The Ewing bill only extends to stock futures a small fraction of the anti-fraud and anti-manipulation provisions contained under the federal securities laws. In addition, it does not provide the SEC with rulemaking and exchange oversight authority, which are necessary to ensure that appropriate market conduct is adequately defined and enforced.
- Stock futures must be traded in an environment that permits and fosters multiple trading and adherence to best execution of customer orders. National Market System principles, including the establishment of market linkages, the availability of realtime quote and trade information, and assuring the practicability of brokers being able to execute investors' orders in the best market must apply to these instruments. The SEC has significant experience in this area. On the other hand, the CFTC has little or no experience in applying these principles. Moreover, application of these principles should be consistent with those applied to securities markets. Accordingly, we believe the SEC should be vested with

the authority to apply NMS principles to stock futures, as it does to stocks and stock options.

- Some form of centralized or linked clearing should be mandated for stock futures. This is necessary to promote competition in stock futures across markets for stock futures. For example, centralized clearing would help to ensure that positions opened on one exchange could be closed on another exchange.
- Tax treatment of stock futures must be made consistent with that which applies to stock options. Unless the tax laws are changed, customer transactions in stock futures (traded on either a futures exchange or securities exchange) would be subject to favorable "60/40" treatment. Essentially, this means that customers of exchange-traded equity options would be subject to a higher tax rate than customers of stock futures. This violates a longstanding congressional policy of providing equivalent tax treatment for competing products on the options and futures exchanges. The disparity can be addressed either by extending 60/40 tax treatment to equity options or denying 60/40 tax treatment to stock futures. The implementation of any stock futures legislation could also be made contingent on achieving tax parity between stock options and stock futures.
- Section 31 fees should apply to stock futures. Imposing this fee on securities markets but not on futures markets would provide an unfair competitive advantage to the futures exchanges. In addition, given that the Ewing bill essentially provides that the SEC shall police the stock futures markets against insider trading and enforce the handful of several other enumerated securities protections, it seems appropriate that the futures markets help fund the SEC budget. Applying Section 31 fees would be appropriate in this regard.
- Unless equivalence of regulation between stock futures and other securities products can be assured, the securities exchanges would need certain regulatory relief in order to remain competitive. For example, the exchanges would need to be freed from procedural requirements, such as SRO rule filings, that can cause significant delays and roadblocks to changing business practices and creating new products. Essentially, securities exchanges would be facing direct competitors operating in a deregulated environment (especially when compared to today's securities exchange markets). They would need to be able act quickly to respond to changing market conditions.
- There are numerous provisions in the Ewing bill that can be construed to expand CFTC jurisdiction over instruments that are securities. For example, new Section 2(c)(2) on pages 18-19 gives the CFTC jurisdiction over options on a commodity (other than foreign currency or a security) traded on an organized exchange. The parenthetical does not include all securities options, specifically options on a group or index of securities. Second, the bill creates an entity under CFTC jurisdiction called a derivatives transaction execution facility ("DTEF") which is a less-regulated version of a board of trade. New Section 5a(e) would allow a DTEF to trade contracts or transactions involving excluded commodities that would otherwise be excluded from the CEA under H.R. 4541. These excluded contracts or transactions would include many securities, such as government securities options, stock options, etc. The bill should be fixed to prohibit a DTEF from trading any instruments excluded from the CEA. There are other places in the bill that might impinge on SEC jurisdiction. The SEC and Commerce Committee should carefully review the bill and identify provisions that affect the regulatory jurisdiction of the SEC.
- We will separately provide a line-by-line set of comments on the Ewing bill shortly.

Mr. DINGELL. I agree with many of their comments. I also ask to include in the record a copy of the February 9, 2000 letter that Mr. Towns, Mr. Markey and I sent to the SEC setting forth questions that we believed had to be satisfactorily addressed on this matter. I would observe that the bill before us does not meet any of the tests that we set forth for a good bill.

[The letter follows:]

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON COMMERCE
February 9, 2000

The Honorable ARTHUR LEVITT
Chairman
Securities and Exchange Commission
450 5th Street, NW.
Washington, D.C. 20545

DEAR MR. CHAIRMAN: We are writing concerning the recommendations regarding single stock futures that were made in the November 9, 1999, Report of the President's Working Group on Financial Markets, entitled Over-the-Counter Derivatives Markets and the Commodity Exchange Act.

As you will recall, the principal focus of the aforementioned report was to address legal uncertainty and unnecessary regulatory burden questions arising from the treatment of over-the-counter ("OTC") derivatives under the Commodity Exchange Act ("CEA"). The Working Group made recommendations with respect to broadening the swaps exemption from futures regulation under the CEA, excluding certain electronic trading systems for swaps from CEA regulation, promoting development of clearing systems for OTC derivatives, and providing authority to exempt certain exchange-traded derivatives from CFTC regulation. While we have a number of questions and concerns about these recommendations, we are writing you today to request information and assistance in understanding the far-reaching implications of the Working Group's recommendation regarding single stock futures.

The report states at page 32, in a section on Other Issues, that: "The Working Group members agree that the current prohibitions on single-stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved." The report then goes on to note that:

"From the perspective of the securities laws, the issues raised by trading of single-stock futures include levels of margin, insider trading, sales practices, real-time trade reporting, and activities of floor brokers, as well as the exclusive jurisdiction of the CFTC over futures contract markets. From the perspective of the commodity futures laws, the issues raised by these instruments include clearing, segregation, large trader reporting, and direct surveillance."

The Working Group unanimously recommended that the SEC and the CFTC "work together and with Congress to determine whether the trading of single-stock futures should be permitted and if so, under what conditions." (emphasis added)

In light of the highly qualified and conditional nature of the Working Group's recommendation in this area, and the enormous complexities involved in satisfactorily resolving all of the issues raised by trading of single-stock futures, we note with some concern the recent request by our colleagues, Representatives Combest, Ewing, Bliley, and Stenholm, for the SEC and the CFTC to "create and present to Congress a detailed legislative plan for repealing the current prohibition on single stock futures" no later than February 21, 2000 so that "it may aid us as we consider reauthorization of the Commodity Exchange Act this session."

This request appears to presume that all of the issues that were identified by the Working Group regarding the integrity of the underlying securities market and regulatory arbitrage either are unimportant or can be successfully resolved in a short period of time. We are not at all certain that these issues can be resolved consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets, especially if done in haste and within the confines of a regulatory structure that bifurcates regulatory authority over certain financial derivatives between the SEC and the CFTC. As the Commission considers this matter, we believe it absolutely imperative that the integrity of our nation's securities markets and the protections afforded to investors in these markets not be undermined in any way. Accordingly, we respectfully request, before the Commission submits any detailed legislative proposals to Congress relating to this matter, that it satisfactorily address the questions enclosed with this letter.

Thank you for your assistance and cooperation in responding to this inquiry. Should you need additional information about this request, please have your staff

contact Mr. Jeffrey S. Duncan (Rep. Markey) at 202-225-2836 or Ms. Consuela Washington (Rep. Dingell) at 202-225-3641.

Sincerely,

JOHN D. DINGELL,
Ranking Member, Committee on Commerce

EDWARD J. MARKEY
*Ranking Member, Telecommunications, Trade and Consumer Protection
Subcommittee*

EDOLPHUS TOWNS
Ranking Member, Finance and Hazardous Materials Subcommittee

cc: The Honorable Tom Bliley
The Honorable Michael G. Oxley
The Honorable Larry Combest
The Honorable Thomas W. Ewing
The Honorable Charles W. Stenholm

Enclosure

QUESTIONS FOR THE HONORABLE ARTHUR LEVITT, CHAIRMAN, SECURITIES AND
EXCHANGE COMMISSION

February 9, 2000

1. Single stock and narrow-based stock index futures (as well as options on those products) would function as very close substitutes for stocks and stock options. Would the availability of these products pursuant to a regulatory scheme that does not contain all of the protections afforded under the federal securities laws undermine the policy objectives of such laws?

2. If single stock and narrow-based stock index futures (as well as options on those products) were to be permitted and regulated other than as securities, how would the SEC be able to protect and ensure the integrity of the underlying securities?

3. Would the futures markets become the price discovery market for stocks? If so, what protections should be in place to ensure prices are established in fair manner? How important is it for the SEC to be able to establish and police such protections?

4. If single stock futures (or options on such futures) were permitted, would it be beneficial to the public to be able to trade them on multiple exchanges and over-the-counter? If so, what market linkages would need to be in place to ensure investors get the best available price?

5. Should single stock futures (or options on such futures) be subject to centralized clearing? If not, what competitive impediments are associated with issuing and clearing such products through other clearing mechanisms, particularly if multiple trading is permitted?

6. If single stock and narrow-based index futures (or options on such futures) were not regulated as securities, how would insider trading be addressed? The futures exchanges have suggested empowering the SEC with the ability to apply insider trading rules to single stock futures to the same extent as it applies those rules to options traded on a securities exchange. Do you believe this would be an effective approach? How much responsibility does exchange surveillance play in this process of deterring and detecting insider trading? Would the SEC need to have authority to oversee futures exchange surveillance programs to ensure that insider trading was being adequately policed? Would the SEC need to have the authority to establish books and records requirements in order to enforce compliance with insider trading restrictions?

7. In addition to insider trading, how would more general market manipulations be addressed? Frontrunning? How much responsibility does exchange surveillance play in this process of deterring and detecting market manipulation or frontrunning? Would the SEC need to have authority to oversee futures exchange surveillance programs to ensure that market manipulation and frontrunning prohibitions were being adequately policed? Would the SEC need to have the authority to establish books and records requirements in order to enforce compliance with applicable market manipulation and frontrunning restrictions?

8. What is the appropriate margin scheme that should be applicable to single stock and narrowbased stock index futures (or options on such futures)? Should stock and stock index futures margin levels be harmonized with those applicable to securities products? Should a single regulator set and administer the process? The futures exchanges have suggested that they would be willing to apply stock options

margin treatment to single stock futures. Would this mean a margin of 20%? Who would approve changes to this level?

9. We understand some trading of single-stock futures has taken place on markets outside the U.S. Have you studied the impact that trading of such products has had on the underlying stock markets? As a general matter, how are such products regulated? Is the regulation of futures, options, and stocks subject to a single regulator in such markets? If so, do you believe this plays a significant role in any apparent successful oversight of such products?

10. If single stock and narrow-based stock index futures (or options on such futures) were permitted and not regulated as securities, presumably the products would be subject to either CFTC supervision or some type of dual Jurisdiction shared between the SEC and CFTC. Either scheme, if designed to address the numerous existing regulatory disparities between securities and futures products, would create an additional layer of regulation on the financial services community. Would this result in excessive compliance costs for the financial community? Is it preferable to link consideration of reform of the Shad-Johnson Accord with broader regulatory reform, such as merging the SEC and CFTC, and harmonizing the laws for all stock-based exchange traded products?

11. What expertise does the CFTC have that would justify it as being considered as the sole or primary regulator for single stock and narrow-based stock index futures contracts? There is movement to convert the CFTC into a "supervisory" agency. How would any such reorganization affect the CFTC's ability to adequately oversee stock-based futures trading?

12. Exchange-listed stocks and stock options are subject to listing standards that help to ensure that adequate information about the underlying instrument is available (i.e., in compliance with securities registration provisions) and a base level of market liquidity is present (i.e., minimum public float and holders). What standards should apply to single stock and narrow-based stock index futures (or options on such futures)?

13. What audit trail requirements should be applicable to single stock and narrow-based stock index futures (or options on such futures)? Should the futures exchanges be required to implement audit trails as precise and extensive as in the securities markets?

14. What securities market transparency provisions, such as quote dissemination and transaction reporting requirements, should apply to single-stock and narrow-based index futures (or options on such futures)?

15. Narrow-based stock index futures are currently banned along with single stock futures because they can act as surrogates for futures on individual securities. Do you believe that any relaxation of the current ban on narrow-based stock index futures would undermine the policy objectives of the Shad-Johnson Accord?

16. Should consideration of modifying the Shad-Johnson Accord be linked with consideration of whether the exclusive jurisdiction clause of the CEA should be removed? Would removal of the exclusive jurisdiction clause pave the way for securities exchanges to offer futures or futures-like products, such as index participations and zero-strike options?

17. What is the appropriate disclosure regime for single stock and narrow-based stock index futures (or options on such futures)? For example, should an equivalent of the Options Disclosure Document apply? Should there exist enhanced risk disclosure requirements for stock futures as is required for penny stocks and day traders? For uncovered options writing?

18. What regulatory requirements should apply to single stock futures (or options on such futures) to address their possible use in connection with obtaining control of publicly traded companies? For example, should Regulation 13D of the Exchange Act or an equivalent provision apply to these products?

19. What regulatory requirements should apply to single stock futures to address their use by entities engaged in distributing securities related to the futures products? For example, should Regulation M of the Exchange Act or an equivalent provision apply to these products?

20. The best execution standards applicable to securities brokers serve an important investor protection function in the equities and options markets. We are not aware of any similar standards applicable in the futures markets. If single stock futures (or options on such futures) were traded on multiple markets, do you agree that best execution standards would be critical to the fair operation of those markets? If such standards were applicable, how would they work, particularly if certain key market transparency measures, such as real time quote availability (with size) and market linkages, were not available?

21. Heightened sales practice and suitability requirements apply to securities options transactions. We are not aware of the existence of similar standards in the

futures markets. Do you believe such heightened standards should apply to single stock and narrow-based stock index futures (or options on such futures)? What would be the results if they did not apply?

22. Should the short swing profit restrictions contained in Section 16 of the Exchange Act apply to single stock futures (or options on such futures)? What would be the results if they did not apply?

23. Assuming insider trading and other anti-manipulation provisions were applied to single stock futures, how would issuer repurchase transactions through the use of futures be addressed? Would an equivalent of Exchange Act Rule 10b-18 be warranted or necessary?

24. If single stock and narrow-based stock index futures (or options on such futures) were traded on futures exchanges, would additional intermarket coordination mechanisms be necessary? For example, would trading halt policies need to be synchronized? Who would mandate and oversee this process? Would surveillance monitoring programs need to be coordinated? What regulator would oversee this process?

25. In addition to the disparities that exist between securities and futures products with regard to policies designed to protect the market and investors, a number of competitive disparities also exist that might place securities markets in an unfavorable position vis-a-vis the futures markets unless addressed. For example, favorable "60/40" capital gains treatment is available to all futures products; however tax code changes would need to be made to broadly extend such treatment to securities markets. Also, securities markets are subject to Section 31 transaction fees. There exists no equivalent under the futures regime. Should these and other competitive disparities be fully addressed in connection with any revisit of the Shad Johnson Accord?

26. Section 11A of the Exchange Act requires the securities markets to consolidate last sale prices and quotations and make the data available on a real-time basis. The CEA does not contain a similar requirement. If this situation persists and multiple futures markets trade single stock futures (or options on such futures), it would be difficult for equity investors to accurately ascertain the price of any particular stock futures contract during the trading day. As part of any plan to permit single stock futures, would it be desirable to require the futures markets to consolidate market data and make it available to all investors?

27. If single stock and narrow-based stock index futures are permitted, should the regulation of all securities and securities-based derivatives be consolidated under one regulator? How can the Shad-Johnson prohibition be lifted unless the SEC and CFTC are merged?

28. The ability of investors to recover damages under the federal securities laws exists for cases involving manipulation and fraud (as well as insider trading) associated with the purchase or sale of securities. Are identical protections afforded to investors under the commodities laws with regard to manipulation and fraud? If not, should investors in single stock and narrow-based stock index futures (or options on such futures) be afforded such protections?

29. The securities options exchanges maintain rules imposing limits on the aggregate number of options contracts that a member or customer may hold or exercise. These rules are intended at least in part to prevent the establishment of options positions that can be used to manipulate or disrupt the underlying market so as to benefit the options position. Should similar limits be applied to single-stock and narrow-based stock index futures? Who would approve and oversee the enforcement of such limits? Should any changes be coordinated between securities and futures markets?

30. The futures exchanges have informally suggested ways of addressing margin and insider trading concerns associated with permitting stock index futures (or options on such futures). What are the complexities and limitations with their approach? Of course, margin and insider trading are but two of many protections afforded under the federal securities laws. How would these other protections be replicated for single stock and narrow-based stock index futures? If not replicated, would the absence of such protections invite regulatory arbitrage, thereby undermining the federal securities laws?

31. Large trader reporting is a key requirement of the CEA. Large trader reports are the linchpin of the CFTC's and futures markets' surveillance systems. The Government Securities Market Reform Act of 1993 gave the Treasury large position reporting authority for the Treasury securities markets, which it uses to monitor trading in Treasury bills, notes, and bonds. The Market Reform Act of 1990 gave the SEC the authority to implement a large trader reporting system, but the SEC has failed to do so. The trading of single stock futures would make the connections between the equities and futures markets even closer than they are today. Given this close connection and the importance of large trader reporting system in preventing

futures markets manipulations, shouldn't a large trader reporting system on the equities markets be a necessary precondition to permitting single stock futures?

32. If single stock and narrow-based index futures (or options on such futures) were permitted, would the SEC have adequate resources to police this additional market for insider trading, market manipulation, frontrunning, or other abuses? If not, please provide an estimate of what additional resources and personnel would be needed?

Mr. DINGELL. Mr. Chairman, I am highly skeptical about the wisdom of authorizing single-stock futures or futures on narrow stock indices or narrow groups of stocks.

As the GAO warned in its April report, even a small price movement in the underlying stock could encourage attempts to manipulate stock prices. I would note to you at this time, Mr. Chairman, that there is growing concern about the efforts of organized crime to penetrate and to manipulate the markets. This certainly will assist that group in their nefarious attempts.

I would note that futures are a highly leveraged zero sum game. A lot of people are going to get burned in this, and trust in the market as well as volatility are going to be moved into dangerous levels and dangerous areas. The stock markets have been the envy of the world in this country, and they will be reduced to a commodity with futures markets being the price discovery point. This concerns me. Nevertheless, if it is the judgment of my colleagues that we should authorize these ill-advised instruments, it is absolutely imperative that the integrity of the Nation's securities markets and the protections afforded investors not be undermined in any way. At a minimum, we need to provide protections substantially similar to those that we have applied with respect to options on stocks and narrow indices.

In closing, I want to assure my colleagues that I approach this issue with an open mind given the general sorry character of the legislation. I have a measure of skepticism about the merit of the bill. I am happy to work with you to try to write a good bill. Barring that, I am committed to using this turkey for target practice.

I would observe that there is much that can be done to improve this bill. Perhaps the best thing to do is kill it, but I am willing to try to make a silk purse out of a sow's ear if that is the wish of the committee. I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back. The gentlewoman from New Mexico, Ms. Wilson.

Mrs. WILSON. I will enter any statement for the record.

Mr. OXLEY. Bless you.

Dr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman. I am looking forward to the testimony today. This is how I see this issue now. If an investor who owns stock in a company worth \$50 a share and is worried about a price drop so he can sell a futures contract, if the stock dropped below \$50 at a specified date, the contract's purchaser must either take delivery on the stock at \$50 a share or pay the investor the difference per share. If the stock climbs above \$50 by the specified date, the investor pays \$50 per share to the contract's purchaser who profits from the rise in value.

I must say, Mr. Chairman, I haven't had a single constituent write me or phone me on this issue so I wonder why this is coming up. What concerns me about this is the margin requirement for a

stock is 50 percent, while the requirement for a futures contract is 5 percent. I am worried that the introduction of single-stock futures will increase speculation on individual issues.

This was something that was a problem back in 1929, and it looks to me like the basic idea is back. The futures markets want to trade single-stock futures which in economic terms are virtually identical to stocks, and I think this enters a lot of volatility and speculation into a market which already may have a lot of speculation and when investors like Warren Buffett, who lives on the edge of my district, are having a hard time figuring out what the proper valuation of a stock price is, I wonder whether the little guy is going to have problems on that, too. So I will be looking forward to your testimony today. I thank you.

Mr. OXLEY. The gentleman yields back. The gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman. The piece of legislation that we are examining today has potential to have a large impact on our securities market. While there are portions of this bill which will bring certainty to our financial markets, I have concern about ending the prohibition on single-stock futures. This committee has long ensured that the Nation's securities market were fair to and protected investors. While we have long understood that investors and the securities market undertook risk and unlike bank deposits were subject to the uncertainty of the market, we have always made sure that the market was fair. We wisely banned insider trading, created the Securities and Exchange Commission to police unfair dealing, and we required that brokers sell products to investors only if suitable for that investor's profile.

H.R. 4541 would allow for the trading of a new financial product, a future based on a single stock. Like options, the value of the future would be directly related to the underlying exchange-traded security. Like options, these products would affect the exchange and the over-the-counter stocks owned by average retail investors. However, unlike options in stocks, they would not be subject to the insider trading prohibition. Brokers would not be held to the same suitability standards for single-stock futures as for exchange-traded securities. Single-stock futures would receive preferential tax treatment. They would be exempt from the SEC transaction fees. They would have a separate margin requirement which could allow consumers to undertake dangerous levels of margin in their pursuit of high-flying returns, only to find earth-crashing bankruptcy.

With so many retail investors in the market and with so many already having problems with the current requirements, and with the SEC continuing combatting stock fraud and market manipulation, with all of these events occurring, now is not the time to remove the rules on a new riskier product. Now is not the time to return the retail investor to the Wild West, where ruthless gunslingers live without rules while individual investors try to stay alive.

Mr. Chairman, I am not opposed to the creation of a new financial product which may provide benefits to both institutional and retail investors, I certainly support insuring that our financial markets continue to be the world leaders. However, allowing an exchange to sell a high-risk product to retail investors without the

protection of our Nation's security laws will not improve our markets, it will harm our markets.

I look forward to this hearing and working with you to improve this legislation to protect retail investors. I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back. The Chair recognizes Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman. In George Orwell's 1984, one of the worst things you could do was to commit the offense of crime think. That was the act of even thinking bad thoughts about Big Brother or the Party. It was a very serious offense. We are here today because Brooksley Born, the former chair of the CFTC, committed an act of regulatory crime think. She issued a notice to the world that the CFTC was thinking about whether it should step up oversight for the OTC swaps market. How shocking. How terrible. The swaps dealers went berserk. The Fed and Treasury had conniptions. Congress passed a moratorium on any CFTC's consideration of Brooksley Born's ideas and now we are considering legislation aimed at making certain that no future CFTC ever, ever, ever commits regulatory crime think again.

Now, those of us who served on the conference committee on the Futures Trading Practices Act of 1992 thought we had already addressed the issue of the status of the OTC swaps under the Commodities Exchange Act. We included a provision aimed at providing the swaps dealers legal certainty that swaps would not be regulated as futures. At the time the dealers hailed this as solving the legal certainty problem. But now 8 years later, we are told we need to fix the fix we made.

Now I have no objection to doing this, but it seems like a bit of an overreaction. But more disturbingly, this bill contains a provision which would repeal the restrictions on single-stock futures. Last year the President's Working Group on Financial Markets stated the Working Group members agree that the current prohibitions on single-stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved. The report goes on to note that from the perspective of the securities laws, the issues raised by trading of single-stock futures include levels of margin, inside trading, sale practices, real time trade reporting and activities of floor brokers as well as the exclusive jurisdiction of the CFTC over futures contract markets. From the perspective of the commodities futures laws, the issues raised by these instruments include clearing, segregation, large trader reporting and direct surveillance.

The Working Group unanimously recommended that the SEC and CFTC work with Congress to determine whether the trading of single-stock futures should be permitted and, if so, under what conditions. In light of that highly qualified and conditional Working Group recommendation in this area and the enormous complexities involved in satisfactorily resolving all of the issues raised by the trading of single-stock futures, I believe that this Congress is moving too quickly to approve legislation in this area. I believe it is absolutely imperative that the integrity of our Nation's securities markets and the protections afforded to investors in these markets not be undermined in any way. Accordingly, I believe we must ei-

ther transfer jurisdiction over stock index and single-stock futures to the SEC, or delete the bill's provisions allowing for single-stock futures.

I yield back the balance of my time.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF LOUISIANA

Thank you Mr. Chairman.

Mr. Chairman, I will keep my remarks this morning very brief as I am eager to hear from Chairman Arthur Levitt of the SEC, as well as from our other distinguished witnesses here today. But let me take just a moment to frame the main issue before us as I see it.

We are here today to discuss a bill, H.R. 4541, that attempts to do a good thing: Modernize the Commodity Exchange Act (CEA). Modernization of the CEA, I think, is needed considering that the "Shad-Johnson Accord," which is codified in the CEA, has left us with a great deal of legal uncertainty when it comes to regulating specific, complex financial products out there today.

Specifically, H.R. 4541, would, for the first time, permit the trading of "stock futures" despite that the CFTC and the SEC have never been able to reach an agreement on their respective jurisdiction over such futures as the Shad-Johnson Accord contemplated they would.

While I am not opposed to the debut of stock futures trading on our exchanges, I don't believe that this bill, as reported out of the Agriculture Committee, adequately addresses the complex investor protection and competitive fairness issues that need to be considered.

The bill as drafted does not treat stock futures as securities and does not provide the SEC with the authority to supervise their trading. Consequently, H.R. 4541 does not provide an appropriate regulatory framework for the trading of stock futures, and herein lies the main problem with this bill.

Though it is an obvious point, "stocks," or literally, units of equity ownership in a corporate entity, are the most widely traded securities that we know of today. It only stands to reason then that "stock futures"—or agreements to buy or sell actual SECURITIES for a fixed price, at a specified point in time—should be subject to at least some oversight from the SECURITIES and EXCHANGE COMMISSION.

If we treat stock futures as commodities, and exempt them from the application of the federal securities laws—as H.R. 4541 proposes to do—my fear is that these futures will serve as surrogates for individual stocks and will be marketed to retail investors across the country—free of basic disclosures...registration requirements...and other important investor protections that are the bedrock of securities regulation in this country.

Now I have been a member of this Committee of sometime, and I need look no further than our experience with H.R. 10 to realize that jurisdictional battles in the context of financial services legislation are hard fought.

But in this case, I believe that Chairman Levitt, many members of this Subcommittee, and the vast majority of the securities industry participants probably share my concerns about the stock futures provisions of this bill. In addition to the SEC, the New York Stock Exchange (NYSE), the Securities Industry Assc. (SIA), the Chicago Board of Options (CBOE), and the National Assc. of Securities Dealers (NASD) all oppose H.R. 4541.

So, let me close by saying that I don't think it would be wise for this Subcommittee, or this Full Committee, to adopt CEA modernization legislation without addressing the concerns raised by these parties.

With that Mr. Chairman, I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back. In deference to the distinguished Chairman of the SEC, we are going to go forward with the hearing. The Chair will stay here and we will proceed.

Mr. LEVITT. Where has everybody gone?

Mr. OXLEY. This is a vote on the Journal. It is usually a device of the leadership to find out how you are going to vote on a particular legislation. I prefer to keep the leadership in the dark as far as my vote is concerned, and would rather hear from the distin-

guished Chairman of the SEC. It is an honor to have you back again to our committee and you may begin.

**STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION**

Mr. LEVITT. Thank you very much, Chairman Oxley and thank you for the opportunity to address this subcommittee concerning H.R. 4541. This bill would provide legal certainty for over-the-counter derivatives and lift the ban on single-stock futures. As you know, the Commission fully supports both of these objectives. In some important respects, however, I firmly believe that the bill presents serious and unwarranted risks to the investing public as well as to our securities markets.

As we consider the implications of the bill, it serves us well to remember both the wisdom embodied in our securities regulatory framework and the prosperity that it has fostered. Its wisdom I think is quite simple: A recognition that protecting investors is not just the right thing to do, but the smart thing to do; that it is investor confidence that ultimately fuels competition; that vibrant markets rest on a foundation of integrity. I strongly believe that the unequivocal commitment to protecting investors made by your predecessors and mine has been critical to the success of the Nation's securities markets.

The bill before you, consistent with the Working Group's recommendations, goes a long way toward providing greater legal certainty for OTC derivatives by excluding certain products from the CEA. In some important respects, however, the bill differs from the Working Group's recommendations. My staff and I would be glad to go into detail and discuss with you the particulars of those differences. The bill would also lift the ban on single-stock futures contained in the Shad-Johnson Accord. Now, I don't have any particular interest in justifying the historical origins of the ban today. I have made clear my view that market demand and not regulatory fiat should determine the availability of investment vehicles. But I do think we should squarely face the fact that single-stock futures are an economic substitute for the underlying security. We must not ignore the fabric of protections that retail securities investors rely on and the confidence that these protections engender. Some may dismiss this concern as kind of a guise for the protection of turf. I assure you that the questions surrounding how best to ensure that regulatory disparities do not erode investor confidence are profoundly serious and substantive.

Building upon the CFTC's acknowledgment that we should jointly regulate these products, the SEC staff has crafted a plan under which these products can trade. In my judgment, an enduring regulatory framework must have a number of salient elements. First, single-stock futures are undeniably a proxy for stocks and stock options. Thus, the framework must recognize the legitimate interests of both the SEC and the CFTC in determining how best to regulate these products.

Second, the framework must encourage fair competition among markets by, for example, including mechanisms to harmonize the regulatory requirements across the securities and commodity markets, particularly with respect to margin. Competitive market

forces, rather than government regulation, should pick the winners and pick the losers. Legislation also should facilitate the listing of the same single-stock futures on multiple exchanges. This would avoid any one market having an exclusive franchise by forcing all markets to compete for investors' business.

Third, the framework must acknowledge that single-stock futures will be retail products. While complex derivative products might not attract retail customers, a simple future on a share of a blue chip stock is sure to do so. Investor protection therefore becomes absolutely essential, as does clear and direct SEC authority over market participants that trade single-stock futures.

Finally, the framework must avoid any harm to existing capital markets. In lifting the ban on single-stock futures and reopening jurisdictional issues, legislative changes should not take away existing SEC authority over financial products. The Shad-Johnson Accord clarified the SEC's jurisdiction over securities options. That jurisdiction should not be diminished in any way, nor should legislation eliminate the SEC's existing role in evaluating products such as stock indices.

I firmly believe that the commitment to protecting investors embodied in these four principles is essential to maintaining the quality of our markets as well as our global competitive edge. Unfortunately, the bill in its current form simply fails to honor that commitment.

I would be happy to provide whatever assistance you may need as you consider these important issues. Thank you very much.

[The prepared statement of Hon. Arthur Levitt follows:]

PREPARED STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman Oxley and Members of the Subcommittee: I am pleased to testify today on behalf of the Securities and Exchange Commission ("SEC" or "Commission") as you consider H.R. 4541, the Commodity Futures Modernization Act of 2000. My testimony today focuses on two key topics. First, I address OTC derivatives markets. Second, I address the competition, investor protection, and market integrity issues raised by single stock and stock index futures.

I. LEGAL CERTAINTY FOR OTC DERIVATIVES MARKETS

As you know, the President's Working Group on Financial Markets ("Working Group") issued a report last year on OTC Derivatives Markets and the Commodity Exchange Act ("OTC Derivatives Report").¹ The OTC Derivatives Report contained several recommendations related to legal certainty for OTC derivatives products.

The enormous size of the OTC derivatives markets² demonstrates their critical role in our capital markets. Derivatives contracts play a crucial role in risk management for a vast array of businesses. Accordingly, I can think of few more important issues for Congressional consideration than legislation to implement the recommendations by the Working Group to give legal certainty to the OTC derivatives market. The Commission reiterates its strong support for implementation of the recommendations by the Working Group related to legal certainty for the markets that trade these products.

The Working Group was given a fairly narrow task—to determine whether the Commodity Exchange Act ("CEA") provided an appropriate regulatory framework for the OTC derivatives markets. The Working Group unanimously concluded that

¹ Report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (Nov. 1999).

² According to data from the Bank for International Settlements, at the end of June 1999, the total estimated notional amount of outstanding OTC derivative contracts was \$81.5 trillion. *The Global OTC Derivatives Market at end-June 1999*, 45/1999E (Nov. 25, 1999) <<http://www.bis.org/press/index/htm>>.

for certain OTC derivatives the CEA was not the appropriate framework. In addition, the Working Group determined that steps needed to be taken to ensure that the CEA did not stifle the natural development of these markets. For a more detailed discussion of the Working Group's recommendations, I refer you to earlier Commission testimony.³

The consensus achieved by the Working Group was of historic significance. Four of the leading U.S. financial regulators unanimously agreed that the Report's recommendations, which reflected their combined regulatory expertise, urgently required implementation. The Commission strongly supports the efforts made in H.R. 4541 to further the goals of the Working Group. However, as we have stated in the past, it is not necessary to link resolution of all of the issues raised in the bill to the passage of the much needed provisions on legal certainty for OTC derivatives.

H.R. 4541 differs from the Working Group's recommendations regarding legal certainty in several key respects. For example, the Bill does not fully adopt the Working Group's recommendations on the regulation of clearing systems. By expressly providing that clearing agencies registered with the SEC may voluntarily register with the CFTC even though they are not required to do so, the Bill creates potential issues as to which set of regulations would prevail in the event of a conflict. The Working Group specifically recommended that a clearing system regulated by one agency should not become subject to regulation by another agency as a result of clearing OTC derivatives. The Commission staff would be happy to discuss those differences in detail with you or your staff and provide technical assistance to the Subcommittee.

The Commission continues to strongly support the implementation of the Working Group's recommendations that are designed to provide legal certainty for the OTC derivatives markets. Those recommendations should be implemented immediately. We appreciate the Subcommittee's efforts in furtherance of this goal, and we are committed to working with you as modifications are made to this bill.

II. LIFTING THE BAN ON SINGLE STOCK FUTURES

The Commission supports lifting the ban on single stock futures as soon as the regulatory issues underlying that ban are resolved. This year, the Commission devoted tremendous staff resources to designing a legislative framework to permit the trading of single stock and narrow-based stock index futures. Disparities between futures and securities regulation made this a difficult task. As a result of our efforts, however, the Commission strongly believes that these products can trade under the regulatory system that we have outlined below. the regulatory system that I will outline for you today.

Among other things, the Commission staff focused on issues raised by the Working Group. In its OTC Derivatives Report, the Working Group identified several issues that would have to be addressed before trading of single stock futures can begin. Furthermore, the Working Group noted that these issues were best resolved by the Commission and the CFTC.

The CFTC and the SEC engaged in extensive discussions on this topic. Chairman Rainer and I have not agreed on all aspects of a regulatory framework for single stock futures. However, we did reach agreement on fundamental principles for creating such a framework.⁴ Most important among these principles was that single stock futures should be subject to joint regulation by the CFTC and the SEC. This is a positive step forward from outdated notions of exclusive jurisdiction and the

³ See Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning the Report to Congress on Over-the-Counter Derivatives Markets and the Commodity Exchange Act by the President's Working Group on Financial Markets, Before the Senate Comm. on Agriculture, Nutrition, and Forestry (Feb. 10, 2000). See also Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning Recent Recommendations by the President's Working Group on Financial Markets, Before the House Comm. on Banking and Financial Services (Apr. 11, 2000); Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning the Report to Congress on Over-the-Counter Derivatives Markets and the Commodity Exchange Act by the President's Working Group on Financial Markets, Before the Subcomm. on Risk Management, Research and Specialty Crops, House Comm. on Agriculture (Feb. 15, 2000).

⁴ Letter from the Honorable Arthur Levitt, Chairman, SEC, and the Honorable William Rainer, Chairman, CFTC, to the Honorable Larry Combest, Chairman, House of Representatives Committee on Agriculture, the Honorable Tom Bliley, Chairman, House of Representatives Committee on Commerce, the Honorable Tom Ewing, Chairman, Subcommittee on Risk Management, Research, and Specialty Crops, House of Representatives Committee on Agriculture, and the Honorable Charles Stenholm, Ranking Member, House of Representatives Committee on Agriculture (March 2, 2000).

view that because a product can be considered a “future” it should be solely regulated by the CFTC. It reflects movement towards truly modern financial regulation—regulation that recognizes the need for agencies with legitimate regulatory interests and expertise in a product to participate in that product’s oversight.

A. Requirements for a Legislative Framework

1. *General Principles for Markets that are Competitive, Fair, and Free From Fraud and Manipulation*—The process of working through important issues with the CFTC led the Commission staff to identify requirements for legislation to permit the trading of single stock futures. Contrary to what some have suggested, this is not a turf battle between the futures and options markets and the agencies that regulate them. Single stock futures would be nearly perfect surrogates for the underlying securities. As a result, there are fundamental issues of market integrity and investor protection at stake. For this reason, we should move forward in a reasoned and principled manner, as we consider how to permit an entirely new product to trade. If legislation is crafted correctly, markets will compete and regulators will cooperate. I think it would be useful to review the components that we believe are critical for an appropriate legislative framework.

Shared Jurisdiction

First, single stock futures are undeniably a substitute for stocks and stock options, and are fully expected to be a retail product. Therefore, the framework must recognize the legitimate interests of both the SEC and the CFTC in regulating these products. Single stock futures possess attributes of both securities and futures contracts. As a result, joint regulation of single stock futures is appropriate and exclusive jurisdiction is ill advised. Shared jurisdiction and joint regulation entail both recognizing each agency as best qualified to apply the key components of the laws that it administers and coordinating the agencies’ efforts to ensure efficient market regulation that is not duplicative or overly burdensome.

At the practical level, this means ensuring that both agencies have the authority to carry out core functions, and that both encounter no jurisdictional barriers in the suppression of fraud and manipulation. Yet, at the same time, mechanisms should be devised to coordinate on certain costly issues so that the traditional regulator takes the lead.

Encourage Fair Competition

Second, the framework must encourage fair competition among markets. We do not want a framework that lets differences in regulation determine winners and losers. Any legislation should allow both securities and futures markets to enter the competitive fray, but should not give any type of market an artificial competitive advantage.

For example, the SEC and the CFTC should have joint authority to harmonize the margin requirements for single stock futures on an ongoing basis. Otherwise, the market with the more lenient margin requirements will have an artificial competitive edge. Competition should be based on better products, services, and prices—not on regulatory differences.

The legislation also should require coordinated clearing of single stock futures so that a future purchased on one exchange could be offset on another exchange that trades the same type of future. This would allow the same single stock future product to be listed on multiple exchanges. In the options markets, multiple listing has narrowed spreads and reduced prices to investors. Coordinated clearing also makes it more viable for new markets to enter the competitive arena over time. Without coordinated clearing, new markets will not be able easily to offer the same products as competitors.

Protect Investors

Third, the framework must acknowledge that single stock futures will be retail products. Complex derivative products generally do not attract retail customers but a simple future on a share of a blue chip stock will. Accordingly, legislation must maintain the SEC’s ability to protect investors and to maintain integrity of the markets on which they trade. For this reason, the SEC should have clear and direct authority over the markets and market participants that trade single stock futures. I think it is important to explore a few examples of what might happen if the SEC does not have such authority.

In the securities markets, recommendations that brokers make to investors are governed by the suitability rules of self-regulatory organizations subject to SEC oversight. The customer protection regime is quite different under the futures laws. Investors receive a one-time disclosure document informing them that they can lose money on futures. The implications of these differences are quite significant. If the

securities law principle of suitability is not applied to single stock futures, a broker could recommend such a product to any customer with no liability under the securities laws, even if the recommendation was unsuitable for the customer. Moreover, in many cases a broker who sells securities will also be licensed to sell single stock futures. As a result, the SEC is very concerned that investors will not understand that the protections they enjoy when they purchase one product from their broker will not also apply to the other. Worse yet, brokers could have an incentive to offer the riskier single stock futures to investors if they could do so without the suitability responsibilities that attach to the sale of securities. There is no public policy reason to create a framework with such a disparity in investor protections.

Next, consider a corporate insider who learns that his company is about to receive an unsolicited bid to be taken over. The insider buys a substantial amount of single stock futures on a futures exchange and earns huge profits on the transaction. This case involves insider trading that takes money out of the pockets of investors who did not have this information. This is exactly the type of situation that the Commission needs its full authority to address. Without direct authority over the futures exchange or a requirement for insider reporting, the SEC may have difficulty ever learning of the futures purchase by the insider. Such activities could destroy years of Commission efforts to protect investors from insider trading abuses.

Investors also currently rely on the Commission to protect them from unscrupulous, or even just sloppy, practices by investment advisers and mutual fund managers. A bill should not introduce single stock futures into the mix of investment opportunities that investment advisers may recommend to their clients or that portfolio managers may purchase for the mutual funds they manage without regulation by the SEC. This would leave investors in funds consisting of single stock futures without the same protections that investors in mutual funds have enjoyed since 1940.

These are only a few examples, but I hope they illustrate why the investor protections contained in the securities laws should be extended to single stock and narrow-based stock index futures. Please recognize that the SEC's instruments for investor protection are interlinked. Enforcement actions coupled with inspections and the ability to promulgate new regulations are essential ingredients of ensuring the integrity of America's markets. Direct access to audit trails, coordinated market surveillance, inspection authority, as well as suitability and customer protection regulation are all necessary to the SEC's ability to effectively regulate and protect investors. Although the SEC actively pursues people who violate the securities laws, much of our success results from *preventing* problems before a single investor is harmed.

The SEC has many decades of experience and legal precedent in protecting the public—expertise that should be carried over to equity substitutes such as single stock futures. Our securities markets are second to none because of the investor confidence that has flourished under this regulatory framework. It would be extremely unwise to move ahead with legislation that lacks the elements necessary to ensure the market integrity, suitability, and customer protections that investors have come to expect under the securities laws.

Do Not Harm Existing Markets

Fourth, the framework must avoid any harm to existing capital markets. In lifting the ban on single stock futures and reopening jurisdictional issues, legislative changes should not take away existing SEC authority over financial products. For instance, the Shad-Johnson Accord clarified the SEC's jurisdiction over security options, and that jurisdiction should not be diminished in any way. Nor should legislation eliminate the SEC's existing role in evaluating stock indexes for susceptibility to manipulation and compliance with appropriate standards that assure they will not become a surrogate for single stocks. Given the CFTC's exclusive jurisdiction over such futures, the standard put forward in any bill and the SEC's role in applying it must be sufficient to deter insider trading through index futures. Investors have strong expectations about the integrity of markets that the SEC regulates, and the resulting investor confidence fuels the success of those markets. Accordingly, legislation should not eliminate any existing SEC oversight of securities and related markets.

Moreover, we cannot allow market integrity issues in new markets to migrate to existing capital markets. Because there are times when problems in one market may be identified and understood only by reference to another market, legislation must provide for coordinated surveillance of all markets.

Adherence to these principles will leave U.S. markets for these products better positioned to compete against their foreign counterparts. When U.S. markets are forced to compete against each other for investors' business and to maintain the in-

tegrity that promotes investor confidence and attracts additional business, those markets should be leaders in the international arena. As markets around the world compete for customers and capital, one overriding principle will serve as our competitive advantage: the quality of our markets.

2. *Discussion Draft*—The Commission staff has prepared a discussion draft that incorporates these legislative goals into amendments to the federal securities laws and the Commodity Exchange Act. The SEC’s proposal extends the protections of the federal securities laws to single stock futures. However, much of the proposal is devoted to ensuring that those laws do not unnecessarily burden the markets and intermediaries that trade single stock futures. We look forward to comments from the CFTC and to having a dialogue with your Subcommittee on our suggested approach. We are setting out below a brief summary of the principal elements of that plan—a plan that presumes shared SEC and CFTC jurisdiction over these products.

First, this draft framework defines single and narrow-based stock index futures as securities. This triggers SEC oversight and the application of the securities laws. We then focus on detailed regulatory relief for some of these intermediaries and markets as a means to avoid unnecessary or duplicative regulation.

For example, floor brokers on designated contract markets that are already registered with the CFTC would be completely exempt from SEC registration. We also create a simple process of notice registration with the SEC for certain markets and intermediaries that are already registered with the CFTC. Those markets and intermediaries would have to comply only with securities law provisions that are considered “core.” We clearly exempt these markets and intermediaries from the numerous non-core provisions of the securities laws where the CEA and CFTC regulation sufficiently addresses the same public policy concerns.

For the core provisions of the securities laws that would still apply to these entities, we provide innovative ways to relieve their regulatory burdens and to coordinate our regulatory efforts with the CFTC. For example, for many of the proposed rule changes that CFTC-regulated markets would submit to the SEC we have provided for immediate effectiveness of such changes and a limited scope of review. In appropriate areas, such as examinations, we recognize that the CFTC should be the lead regulator for such CFTC-regulated entities and limit our activities accordingly.

In addition to the detailed regulatory relief and coordination provisions, we provide minimum requirements to be incorporated into listing standards for these products. Such requirements, along with provisions related to coordinated clearing, are aimed at promoting market integrity and intermarket competition.

Finally, we incorporate these products into other relevant securities laws, such as the Securities Act of 1933, the Investment Company Act, and the Investment Advisers Act. In doing so, we avoid unnecessarily burdensome regulation under these acts as well.

This discussion draft shows that the protections of the securities laws can be extended to single stock and narrow-based stock index futures while still permitting the efficient operation of our markets. Our discussion draft would achieve the goals of creating a new market for single stock and stock index futures that is competitive, fair, and free from fraud and manipulation. U.S. investors deserve nothing less. U.S. capital markets provide the lifeblood of American business and are the place where American families invest their hard-earned dollars with hopes of earning returns that will provide for everything from their children’s educations to their retirements. We cannot afford to put these markets at risk.

B. Comparison to H.R. 4541

Crafting our plan was not easy. Therefore, I appreciate your efforts in drafting the bill. Moreover, I am heartened by the bill’s attempt to recognize some of the principles that the Commission feels are so important in this area. Unfortunately, the bill as written ultimately does not vindicate those principles and achieve the goals of the legislative framework previously outlined. The bill does not sufficiently extend the protections of the securities laws to single stock and narrow-based stock index futures. The Commission therefore could not support the legislation in its current form.

As you continue to revise your legislation, I would hope your bill ultimately can answer questions, such as the following, in the affirmative:

- Does the bill clarify *in both the CEA and the securities laws* that the SEC has full authority over single stock and narrow-based stock index futures and that the securities laws protections apply to these products?
- Does the bill provide for expedited registration of the intermediaries and exchanges that trade these products with both the SEC and the CFTC?

- Does the bill provide real mechanisms for both the SEC and the CFTC to ensure that the relevant securities and futures regulations, such as those related to margin, remain harmonized on an ongoing basis?
- Are there provisions for coordinated clearing of these products?
- Are there provisions that enable the CFTC and SEC to work together to foster competition in the markets for these products?
- Will both the CFTC and SEC be able to effectively prosecute frauds involving these products?

III. CONCLUSION

Once again, the Commission appreciates the efforts that the Subcommittee has made in bringing derivatives issues to the forefront. We believe that the regulatory provisions that we have set forth can support the work of the Subcommittee in its efforts to repeal the ban on single stock futures and eliminate uncertainty for the OTC derivatives markets in a way that fosters competition, bolsters market integrity, and ensures that no harm befalls America's capital markets or investors.

The Commission appreciates the Subcommittee's efforts with respect to derivatives issues. Just as derivatives products themselves can be complex, so too are the issues that surround these products. Having regulated securities derivative products for decades, the Commission welcomes the opportunity to actively participate in the dialogue about derivative products that your bill will engender. We look forward to sharing our views with your Subcommittee, the Working Group, market participants, and other legislators as changes continue to be considered.

Thank you.

Mr. OXLEY. Thank you, Chairman Levitt. We accept your offer. This is enormously difficult legislation for the committee, as you know. It is very detailed and somewhat arcane, and so your staff and your help would be most appreciated. As you know, we are under a time constraint with the referral of the bill and essentially have until the end of this month. Even though technically we have until September, with the August recess, we are really faced with 3 weeks in which we have to act. The game plan is we have our hearing today, we mark up the bill in our subcommittee next week, and then the full committee the last week in July. So time is of the essence. We are prepared to roll up our sleeves with you and with our friends on the other side of the aisle to try to craft legislation that is in the best interests of the investing public. I think if we all share that same goal, I am sure we do, we can make enormous progress.

Let me begin with some questions. Do you anticipate reaching general agreement on regulation of single-stock futures in time for the committee to reflect that agreement in this legislation?

Mr. LEVITT. I am not certain. The chairman of the CFTC and I have been talking about this issue for a number of months, and I think both of us are motivated by what we believe is in the best interests of our markets and investors.

The issues are very difficult and complex. Our staffs are meeting almost as we talk, and I am told some progress has been made. I have advised our staff that I would be prepared to commit any amount of time to accomplishing a meeting of the minds that would avoid a legislative solution. I think that we are far better able to craft this than anyone else, and, working with our colleagues in the Treasury Department, I can promise you that progress has already been made and more will be made. Whether we can meet the very tight legislative timetable, I simply don't know.

Mr. OXLEY. Is it your goal then, that if in fact everything were to happen the way we would want it, for you to reach an agree-

ment and then we would essentially codify that agreement in the legislation?

Mr. LEVITT. I guess in the best of all worlds that is how it would work. The Commission is motivated exclusively by what we regard as being in the best interest of America's investors. Putting a highly leveraged new product into the hands of America's retail investors at a point in time when the market already has an abundance of speculation is playing a very dangerous game. Because of that, we are greatly concerned that the basic protections that have been afforded retail investors in terms of equity investment be present in allowing a product which is merely a proxy for a retail stock investment.

Mr. OXLEY. Some distinguished people, including Chairman Greenspan, have said publicly they think that unless we lift the Shad-Johnson Accord the business essentially will flow overseas; that is, the traffic in single-stock futures. Does that cause you some concern?

Mr. LEVITT. Let me give you kind of an unorthodox response to that. As Chairman Greenspan knows, we both are passionate believers in free markets, but the notion that we would lose single-stock futures to any market, and that loss could be in any way a danger to the United States economy or the United States markets, I think, is an absurdity. If the world is crying for single-stock options—single-stock futures, let them have them in my judgment. It is not our job to determine what products should or shouldn't be traded, but in my judgment in no way would the U.S. markets or economy be impaired by the loss of that product to other markets. The use of that product in Australia and other parts of the world thus far has been a dismal failure.

My concern is that we are taking legitimate market products, the futures market, which has been largely an institutional market, transferring it to a retail incarnation and leaving it, according to this bill, without the protections that we give investors in our equity markets.

Mr. OXLEY. Having said that, though, if all of us were able to craft the necessary protections in the marketplace in a regulatory scheme that we would envision, would you then feel comfortable with lifting the accord?

Mr. LEVITT. Yes. You know, the Accord is kind of a jerry-built structure to accommodate what I regard to be an irrational distribution of regulatory authority, but it is what it is, and if there is a way of lifting it and protecting investors, I would enthusiastically support it, as I support other aspects of the bill in terms of relieving the legal uncertainty from the trading of derivatives. I think that is a very important and useful objective, although I fail to see its relationship to this part of the bill. But my answer to your question is very definitely yes.

Mr. OXLEY. If we were to start the world all over again, wouldn't it make sense to have single-stock futures regulated by the Securities and Exchange Commission as securities?

Mr. LEVITT. Absolutely.

Mr. OXLEY. Let me yield to my good friend from New York.

Mr. TOWNS. Thank you, Mr. Chairman.

Could you please give your views on the argument or statement that has been made that markets are hindered by the application of securities regulations? Haven't the options markets thrived under the securities law?

Mr. LEVITT. I remember full well how the options markets were introduced to America's investors. I was the head of the American Stock Exchange at that time, and we were early participants in that market. In those early years, there were all kinds of complaints and scams and scandals involving the use of that new product. We had the unfortunate experience of having to fine and censure 22 specialists on the floor of the American Stock Exchange in connection with the trading of options.

Any new product involves a measure of uncertainty and a measure of risk. Options, because they are more leveraged than common stock certainly represented that.

Now when you take the futures on single securities, they are merely proxies for those securities; and one of the dangers, in my judgment, in this bill is the amount of leverage that is entailed. The amount of borrowing that a retail investor could now embark upon is substantially greater. You are taking a new universe of retail investors, most of whom have never seen a down market, many of whom in my judgment are more leveraged than they already should be, and you are allowing them to use a new product, totally new to them, a future on an individual stock, which will enable them to buy that stock for a fraction of what they would have paid had they bought either an option or the stock itself; and the risk is unlimited in terms of what happens to that future.

And I suggest to you that, if we take that step, if the Congress of the United States is prepared to take that step, we all have a responsibility to America's investors to see to it that they have the same protections that they have when they purchase common stock and common stock options.

Mr. TOWNS. Thank you very much.

According to my staff, you seem to have a plan for trading single-stock futures that could work. Could you please tell us about it? I would like to know more about that.

Mr. LEVITT. We do have a series of recommendations with respect to how single-stock futures could work under the joint oversight of both the CFTC and the SEC. The plan is fairly detailed. We have submitted it to the CFTC. They are considering the plan. They have not yet responded to the plan in detail. It is my hope and expectation that their response to this plan will enable us to move forward together on a response to this legislation.

Mr. TOWNS. Mr. Chairman, I would like to ask that he submit it for the record, submit the plan for the record.

Mr. OXLEY. Without objection.

Mr. LEVITT. We will submit the plan.

Mr. TOWNS. Thank you.

[No response was received by the subcommittee.]

Mr. TOWNS. I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back.

Let me recognize the gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman.

This is an interesting time. It is good to have Chairman Levitt back. A couple of quick questions. I always like to boil it down.

Of course, in your opening statement you mention that this isn't a turf battle, but I would submit that turf battles are pretty important. Especially in our role in the Commerce Committee, we like to protect our turf; and we think that we do so in the best interests of the public as much as the Founding Fathers liked to protect the turf of the executive and the judicial branch. That is not a bad thing, especially if you feel that the turf you are protecting, you are doing it based upon sound principles of protecting the interests of the investors. That is my little opening statement.

Mr. Chairman, some of these questions may have been asked when I went to the vote, but in H.R. 4541, it contemplates a role for your agency in crafting a suitable rule for single-stock futures along with the National Futures Association. You have addressed some of the concerns you have with that. Do you have any additional ones that you may have left out?

Mr. LEVITT. Well, the problem with the aspect of the bill that I think represents a serious risk for America's investors and markets deals with an assumption that the CFTC will oversee this product. The bill really calls for exclusive CFTC jurisdiction. There really is no assurance that there will be the same kind of oversight or regulation as far as the SEC is concerned. Whatever input we have would have to be at the pleasure of the CFTC.

I have suggested before that in light of, again, what I think is an artificial kind of overall regulatory structure, the best way to proceed on this would be joint SEC/CFTC oversight. This bill does not provide for that in any way, shape or form and leaves, in my judgment, America's investors very, very vulnerable.

Mr. SHIMKUS. Let me go on. The bill again states that margins on single-stock futures could not be less than options on the same underlying stock. Further, it gives the Federal Reserve margin authority and even allows it to designate that authority to inter-market margin boards made up of the Federal Reserve, CFTC and the SEC. Do you think that this solution will work?

Mr. LEVITT. No, I think the solution is a contrived solution. I think there is no assurance that the Federal Reserve board will indeed produce such a board; and I—going back to my experience in running very complicated businesses, I reject the notion of boards as a solution to very complicated underlying problems.

Mr. SHIMKUS. And I would just encourage you, we do value your input and especially on this issue. The last thing that we want to do is throw out a product that will put at risk the individual investors. I look forward to working with you and the chairman and, if we move legislation, to move it with your support.

Mr. LEVITT. I appreciate that. Thank you.

Mr. OXLEY. Mr. Rush from Illinois.

Mr. RUSH. Chairman Levitt, I appreciate you being here this morning. You had some insightful and cogent remarks as relates to H.R. 4541. I do have a couple of questions. Are there any benefits to the small investor in the quest to regulate single-stock futures? Are there any benefits and, if so, what are those benefits?

Mr. LEVITT. Congressman Rush, are you asking me if I believe there are significant benefits to the retail investor in the purchase of futures and single-stock futures?

Mr. RUSH. Right. That is the question.

Mr. LEVITT. Again, this is a personal answer. It is based on my experience with handling many, many investors through the years. I think those benefits at best are marginal. I think I have expressed before my belief that this is not a product that America's investors are desperately crying for at this point in time. There are other products I might say the same thing about, but it is everyone's right to do with their money what they will. But I also think it is our responsibility to see to it that we protect innocent investors from products that can be used unscrupulously and from products that represent levels of risk that call for a very specific kind of regulatory oversight.

Mr. RUSH. Although some financial markets feel they would lose business because of participation by the small investors, does the single-stock futures market have enough opportunities to include the small investors' participation?

Mr. LEVITT. I think the experience of other markets with single-stock futures has not proven this to be a very successful undertaking. However, if it does have a potential for success with retail investors in our markets, with the level of speculation that exists today with investors being moved more by emotion than intellect, I think we have to offer those investors the kinds of protections that we have tried to outline in our testimony.

Mr. RUSH. Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back.

If I can just intervene. That was an interesting comment you made in terms of the investors being driven more by emotion than intellect. How would investor protection necessarily aid that individual who is overtaken by emotion?

Mr. LEVITT. Well, my concern about that kind of attitude in our markets is that it does fuel speculation; and much of the Commission's work has been dedicated, through a program of investor education in town meetings, in cautioning investors about scams in the markets at a point in time. Today the emphasis in our town meetings, the emphasis in our brochures and on our website has been to caution investors about borrowing, about margin. Therefore, when we are thinking of introducing a product which will exacerbate the level of borrowing, I think it becomes even more important for us to assure investors that we maintain the basic protections that presently exist in our markets.

Mr. OXLEY. Thank you.

The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Thank you, Mr. Chairman.

I would like to ask you, Chairman Levitt, there really hasn't been a case made for additional CFTC regulation of the over-the-counter energy derivatives market. Why do you believe that additional regulatory jurisdiction is necessary?

Mr. LEVITT. You know, I don't think that I have any feeling about that. That is a CFTC matter, and I really am not familiar with the issue.

Mr. LARGENT. Okay. Are you looking to expand your oversight jurisdiction of the gasoline markets?

Mr. LEVITT. No.

Mr. LARGENT. I have no further questions.

Mr. OXLEY. The gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Welcome, Mr. Chairman.

Mr. LEVITT. Thank you.

Mr. DINGELL. I am glad to see you back here again. I have a series of questions I hope you will answer as briefly as you can because of the large amount of ground we have to cover.

What will be the impact of single-stock or narrow group index futures contracts on the underlying stock market, do we know?

Mr. LEVITT. I don't think so.

Mr. DINGELL. If we lend additional volatility by reducing the margin, by moving these into futures from the normal securities market which has 50 percent margin, what would be the effect on volatility of the market?

Mr. LEVITT. If there was substantial interest in such business, I think it would increase the volatility.

Mr. DINGELL. By what order?

Mr. LEVITT. I don't know.

Mr. DINGELL. Substantially?

Mr. LEVITT. Yes.

Mr. DINGELL. You have had some attempts lately by the Mafia to enter into and manipulate the market in securities. You have been devoting major efforts to addressing that question. What would a 5 percent margin and reduced regulation of futures do to the attempts of organizations like this to manipulate the market?

Mr. LEVITT. I think it would just give them additional opportunities to do their work.

Mr. DINGELL. What would be your ability to deal with those kinds of attempts by Mafiosi and other groups to enter the market for that purpose?

Mr. LEVITT. Under the provisions of this bill, practically nonexistent.

Mr. DINGELL. Have there been any studies of manipulation of the markets?

Mr. LEVITT. With all due respect, I don't think that we need studies to understand the impact of the kind of leverage that we are talking about in terms of manipulation.

Mr. DINGELL. You are talking about leverage because of reduced regulation and—

Mr. LEVITT. And increased volatility.

Mr. DINGELL. Have there been any studies on increased volatilities?

Mr. LEVITT. I am not certain.

Mr. DINGELL. Are there adequate protections and surveillance mechanisms in the bill before us today of the level of magnitude that you at the SEC would be able to apply to securities?

Mr. LEVITT. I don't believe so, sir.

Mr. DINGELL. Is it fair to observe that a future on a single-stock would be, for all intents and purposes, interchangeable with the sale of the stock?

Mr. LEVITT. Absolutely.

Mr. DINGELL. So the investor should have the same protections whether there is a sale of a future or a sale of the underlying security?

Mr. LEVITT. Yes.

Mr. DINGELL. Now, I want you to submit for the record the differences between your ability at the SEC to address insider trading and those at CFTC. It is fair to say, however, that CFTC has much reduced abilities to address the insider trading questions, does it not? Much less than you have?

Mr. LEVITT. I am not precisely certain about the CFTC's abilities in this regard. I do know that we have seen more insider trading today than ever in the history of our markets, and it is one of the major areas of Commission concern.

Mr. DINGELL. If there is reduced authority to address insider trading questions or reduced ability at the SEC to require paper trails and things of that kind because of transference of your responsibilities to the SEC, what would be the impact on investors?

Mr. LEVITT. I think it leaves America's investors extremely vulnerable.

Mr. DINGELL. Would you give us a short statement at your convenience on the differences between insider trading authorities and paper trail requirements at the SEC and the CFTC?

Mr. LEVITT. Yes, sir.

Mr. DINGELL. Are you given adequate authority under this bill to police the single-stock futures markets for insider trading?

Mr. LEVITT. No.

Mr. DINGELL. Why do you say that?

Mr. LEVITT. Because it gives exclusive jurisdiction to the CFTC.

Mr. DINGELL. It also reduces CFTC's authority over insider trading, does it not?

Mr. LEVITT. You know, I don't know the answer.

Mr. DINGELL. Would you, at your convenience, respond?

Mr. LEVITT. Yes.

Mr. DINGELL. So if there was to be some kind of major problem in the market with regard to volatility, with regard to market drop, let's say something like happened in 1987 where the market fell 500 points, and let's say there was some kind of insider trading or manipulation going on, could the CFTC under the authorities it has under this legislation or your agency under the authorities it has under this legislation respond quickly enough to address the problems that might exist there?

Mr. LEVITT. I don't believe so.

Mr. DINGELL. Now, if we are to go forward in lifting the ban on single-stock futures, what regulatory structures should we impose and who should enforce it?

Mr. LEVITT. In my judgment, if we do that, we should recognize and the bill should acknowledge that a single-stock future is a security; and all of the protections offered by the present securities legislation should be available to investors in a single-stock future. We should try to create a kind of regulatory scheme where there is a joint regulation, shared regulation, by the CFTC and the SEC.

Mr. DINGELL. Does this legislation do that?

Mr. LEVITT. It does not do that.

Mr. DINGELL. It has been said that there is no difference between an option and a single-stock future; is that true?

Mr. LEVITT. That is not true. An option has a limited amount of risk. A single-stock future has an unlimited amount of risk. I would suggest to you that a naked option is more closely aligned to a single-stock future.

Mr. DINGELL. So an option you can lose your money but your loss—your potential loss on a single-stock future is unlimited, isn't that right?

Mr. LEVITT. Yes, sir.

Mr. OXLEY. The gentleman's time has expired.

Mr. DINGELL. I thank the Chair. I look forward to continuing this at a later time.

Mr. OXLEY. The Chair now recognizes the gentleman from Iowa, Dr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman.

The idea that stocks are inherently risky and the government should keep people from speculating with excessive leverage was obvious in the 1930's. Then people thought the 1929 crash had been worsened because overleveraged investors were forced to sell. Well, it is hard to remember that 70 years later; and free market advocates claim, if we don't allow such blatant gambling on stocks, the action will go to some overseas market. That seems to be a recurrent theme. We shouldn't let this go to some overseas market. Mr. Chairman, would you comment on that, please?

Mr. LEVITT. Again, I preface that by saying that my response to that may seem personal and impetuous, but my answer to your question is, so be it. If insisting that single-stock futures for retail investors have the same protections that investment in stocks do means we lose that market, so be it. It is a price well worth paying in terms of saving America's investors from the kinds of dangers that an unregulated market would represent.

Mr. DINGELL. Would the gentleman from Iowa yield?

Mr. GANSKE. I would be happy to yield.

Mr. DINGELL. I thank the gentleman.

Mr. Chairman, what has been the rush overseas into single-stock futures where they are offered? It has not been moving fast. It is something on the order of 1 percent?

Mr. LEVITT. That is correct. It has not been successful in Europe or Australia.

Mr. DINGELL. So what they found is that no one really wants these things overseas?

Mr. LEVITT. Thus far.

Mr. DINGELL. I thank the gentleman for yielding.

Mr. GANSKE. The futures market talk of single-stock futures as providing "additional risk management tools," as Scott Gordon, chairman of the Chicago Mercantile Exchange, put it in an interview. They say you can already duplicate in a single-stock future with a complicated trade in the options market, so why worry? Mr. Chairman, would you comment on that?

Mr. LEVITT. You know, in general, some of the products that are in our markets today are ones that I think individual investors have to be very careful about. I think the proliferation of new products in our markets has been a benefit. Our markets are more liq-

uid today than ever before, and I think our futures markets have been a vital part of managing risk. Our futures markets have been largely institutional, and, while I applaud the growth and discipline of those markets and the inventiveness and creativity of new products, when you translate what has been largely an institutional product to a retail product, that is a different ball of wax and one, regardless of the benefits to our institutional markets, whose benefits I think are largely nonexistent to the typical retail investor. And I want to be absolutely certain, and all of us should be certain, that investors know what they are doing and are protected from the kind of leverage that is involved and the opportunity for scam that is created by subjecting investors to this product.

Mr. GANSKE. Mr. Chairman, can you tell us about any scams?

Mr. LEVITT. Well, I could tell you about so many scams, but since America's investors have not had the opportunity to invest in single-stock futures, I can't go into any of those.

Mr. GANSKE. Are there scams overseas?

Mr. LEVITT. I don't know the answer to that.

Mr. GANSKE. I thank you.

Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Mr. Levitt, is there any reason to preclude securities exchanges from trading single-stock futures if they are allowed to trade on futures exchanges?

Mr. LEVITT. No. We have had such extraordinary success at the Commission by forcing our options markets to trade the same options to really let competition work. The impact of that has been to reduce spreads by almost a third. The template is clear. It is there. If we are going to go ahead with a program to introduce single-stock futures, they should be available to every market to compete to reduce the cost of that investment to the benefit of America's investors.

Mr. STUPAK. With the rise in day trading, isn't the potential for increased leverage in the stock market a real concern?

Mr. LEVITT. It is a real concern, yes sir.

Mr. STUPAK. Do you believe that unless the tax treatment and transaction fee treatment for these products traded on a futures exchange or securities exchanged are not rationalized, Congress would be determining winners and losers in the marketplace?

Mr. LEVITT. I think to the extent there are disparities, regulatory disparities and margin disparities, they absolutely would be.

Mr. STUPAK. Could an investor who decided that futures were too risky and chose to invest in equities be harmed by single-stock futures? Specifically, would trading in futures affect the underlying stock price?

Mr. LEVITT. I suppose trading in a single-stock future could affect the underlying stock price. I don't really know what impact that would have because, frankly, I don't know the extent of interest that retail investors would have in this product in the United States.

Mr. STUPAK. Would institutional interest really drive the harm to the market? If you really get into the futures, if the institution

gets into the futures, could that not undermine the value of the market as we know it now?

Mr. LEVITT. I don't necessarily think so. I think that institutions are very sophisticated; and if they choose to use futures as they have used other derivative products to manage risk, I think that is constructive for our markets. I have very few problems with the use of futures as an institutional mechanism.

Mr. STUPAK. I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back.

The gentleman from Maryland.

Mr. EHRLICH. I yield.

Mr. OXLEY. The gentleman yields.

The gentleman from Wisconsin, Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you for coming to Milwaukee for the town hall meeting. I am still getting many compliments for your appearance.

Mr. LEVITT. Thank you.

Mr. BARRETT. I am learning as quickly as I can on this topic, and my understanding is that the reason we are here is back in 1982 this was one of the areas where there was not agreement reached between the SEC and the CFTC and that there still remains some disagreement now.

What I would like you to do is perhaps help me understand where the SEC is coming from on four issues if we have time: the margin levels, the suitability requirements, the enforcement authority and the security transaction fees.

Maybe we can start with the margin levels. I know that was something that Mr. Dingell alluded to in his questioning.

Mr. LEVITT. Well, in brief, the bill that is before us today provides for margin to be determined if—as I understand it, if the Federal Reserve Board goes along with it, the creation of a board that would adjudicate margin differences.

I think that that is a problematic, questionable solution that could very well result in margin levels that are different based upon the product rather than any kind of consistency, and I think that could very well lead to arbitraging margin. And, as Congressman Stupak mentioned before, it represents government choosing winners and losers by determining where the best deal may be; and I don't think that is our job.

Mr. BARRETT. What would be the response from the CFTC on that, do you think?

Mr. LEVITT. You know, I am not certain. But I think the way to respond to that—

Mr. OXLEY. If I can interject, the CFTC will have an opportunity to testify and answer that question soon.

Mr. BARRETT. It is safe to say that is a disagreement between the SEC and the CFTC?

Mr. LEVITT. I am not certain how the CFTC approaches that issue. Our position has been that we have got to work together to see to it that margins are harmonized. I think this bill misses the point by creating what I regard to be a very complicated, problematic kind of solution involving a board. I think we should go directly to the mark and say margin will be harmonized and an in-

vestor will not be able to take advantage of a product because it is traded over there and they have to put up less money than if it is traded over here.

Mr. BARRETT. The enforcement authority issue, obviously an area where you have to have agreement. What is the issue that remains unresolved there?

Mr. LEVITT. The real issue is the basis of CFTC enforcement, which I think is really superb, is largely predicated on the institutional investor and lacks the kind of history that the SEC has in terms of protecting individual American investors. It is almost a cultural difference in that it lacks the self-regulatory organizations that form the basis of a partnership between SEC regulation and New York Stock Exchange and Nasdaq regulation. It lacks a history of inspection, examination, a history of cases predicated on protecting individual investors, a surveillance mechanism, maybe most importantly the whole question of suitability, where the CFTC might say we place a warning up there for investors, warning them that there is great speculation involved in terms of a future.

The SEC requires much more with respect to suitability. Brokers must determine whether a given investor really should be buying a product. It is not enough that a broker tells your Aunt Sally that this future is dangerous. If a broker tells her, yes, it is dangerous Aunt Sally and she chooses to invest in it anyway and she loses her money, under SEC regulation we can prosecute the broker because it is highly unsuitable for Aunt Sally to be buying a dangerous product. Futures regulation is a very different kind of oversight geared toward very different kinds of constituents.

Mr. BARRETT. Thank you.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from California, Mr. Cox.

Mr. Cox. Thank you, Mr. Chairman.

I want to once again welcome Chairman Levitt; and because I am tardy to this hearing, I am going to try to catch up on the testimony. Thank you.

Mr. OXLEY. Let me now turn to our guest panelist, Mr. Ewing, who has a brief statement. The Chair would ask unanimous consent that Mr. Ewing be recognized for 5 minutes for a brief statement. The gentleman from Illinois.

Mr. EWING. Thank you, Mr. Chairman. I don't think that I will take the entire time. I want to thank you for holding the hearing.

And to Chairman Levitt, I have the greatest respect for your knowledge and ability on these issues; and I think that there is—I hope that there is opportunity for this committee working with you to improve the legislation that was sent here dealing with this important subject.

I just have maybe one question. The futures exchanges today are trading stock indices, and I think that the courts have actually said that they could trade narrow stock indices. How do you see the difference between that and the single-stock futures?

Mr. LEVITT. First let me say, Congressman Ewing, that I greatly respect the work that you have done, the background that you have brought to introducing this bill, the sincerity of your motives in

terms of doing something which you believe will be beneficial to America's markets.

I believe that our predecessors who came up with the agreement between the CFTC and SEC and authorized the trading of futures on broad indices felt that that would not have the retail impact that trading a future on a narrow index might have. Now while the courts ruled in that direction, I certainly stand behind the motivation that was displayed before. We need securities laws to apply to indexes that can be manipulated. I think what is important is a question of degree.

In my judgment, trading a broad index represents little or no danger to a retail investor. Trading a narrow based index which does create opportunities for manipulation represents a greater danger to a retail investor. Trading a single-stock future, a future on a single underlying stock, represents, in my judgment, the greatest amount of risk to a retail investor unprotected by the oversight of securities laws.

Mr. EWING. Mr. Chairman, I appreciate your attitude of cooperation and the ability to work on this bill. I believe that we can find a common ground that will protect our investors, protect our markets and make this legislation work; and I certainly look forward to in the next few weeks working with you and with the other parties involved to try and arrange and come to those conclusions and certainly with this committee and other committees of the Congress. Thank you very much.

Mr. OXLEY. Mr. Chairman, we again appreciate your participation in this and look forward to working with you and your staff on these next couple of weeks to try to craft a compromise legislation. Again, thank you for your appearance.

Mr. LEVITT. Thank you.

Mr. OXLEY. The Chair would announce that we have three votes on the floor of the House. I would propose that we introduce our next panel. If they will come forward we will begin your testimony, and then when we have to break we will take a break. Since we have three votes, it will be probably somewhere in the nature of a half hour by the time we get over and get back. The witnesses and others may want to, during that break, have an opportunity to have lunch or whatever; and we will just play it by ear.

Mr. OXLEY. Let me introduce our second panel of the day. C. Robert Paul is General Counsel for the Commodity Futures Trading Commission; Mr. Lewis A. Sachs, Assistant Secretary for Financial Markets, Treasury Department; and Mr. Patrick M. Parkinson, Associate Director, Division of Research and Statistics, at the Federal Reserve.

I am sure that you heard my discussion with Chairman Levitt in regard to the timetable that this committee faces on this important legislation, and we particularly appreciate your coming here with short notice to help us understand this very difficult issue.

We will begin with Mr. Paul.

STATEMENTS OF C. ROBERT PAUL, GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION; PATRICK M. PARKINSON, ASSOCIATE DIRECTOR, DIVISION OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; AND LEWIS A. SACHS, ASSISTANT SECRETARY FOR FINANCIAL MARKETS, DEPARTMENT OF THE TREASURY

Mr. PAUL. Thank you, Chairman Oxley, Chairman Towns and members of the subcommittee. I am pleased to appear on behalf of the Commodity Futures Trading Commission to discuss the important issues addressed in H.R. 4541.

The Commission commends the efforts of Chairman Combest, Chairman Ewing and Congressman Stenholm to modernize the Commodity Exchange Act by introducing H.R. 4541 to provide legal certainty for over-the-counter derivatives, remove impediments to innovation and reduce systemic risk. There are, however, two areas of concern, the scope of the energy exemption and new burdens on our enforcement authority, that preclude the Commission from supporting the legislation in its current form.

The Commission supports the provisions of H.R. 4541 which enhance legal certainty for over-the-counter derivatives by excluding from the CEA certain bilateral transactions and electronic trading facilities. This bill also permits clearing of OTC derivatives and authorizes a mechanism for the CFTC to regulate facilities that clear OTC derivative contracts.

We support this recommendation with the following reservation: The bill would allow securities clearing systems to clear a broader range of contracts than futures clearing systems.

This bill would codify an exemption from most provisions of the Commodity Exchange Act for transactions in energy commodities. This is an area in which H.R. 4541 diverges from the recommendations of the President's Working Group, and the Commission believes that these provisions raise concerns that have yet to be resolved.

The exemption for energy commodities is not governed by the same considerations that form the basis of the Working Group's recommendations with respect to financial products. The President's Working Group stated that the activities of most financial derivatives dealers are already subject to direct or indirect Federal oversight. The same cannot be said of trading in energy derivatives. The President's Working Group also found that most financial OTC derivatives are not susceptible to manipulation. The case has not been made for energy products.

Last month, the Commission published in the Federal Register its comprehensive regulatory reform package, which alters fundamentally the Commission's approach to regulation of markets and participants under its jurisdiction. H.R. 4541 attempts to codify much of the Commission's regulatory reform proposal, and we welcome this support of the Commission's initiative.

The Commission will be moving to oversight regulation in which the agency will no longer act as a gatekeeper and will intervene only when a problem arises. To succeed, however, the Commission must be able to act quickly and effectively to address fraud and

manipulation, as well as to protect the financial integrity of the markets.

Section 15 of the legislation erects several barriers to enforcement action by the Commission. When there is a violation of the core principles, the Commission must delay any action until it provides an appropriate remedy to the violator. Moreover, the bill requires that the remedy be based upon a cost-benefit analysis. Thus, the provision may allow registered entities to postpone and possibly avoid responsibility for violation of core principles.

H.R. 4541 addresses the issue of equity futures contracts and reflects efforts to develop a plan to amend the Shad-Johnson Accord.

The Working Group recommended that the CFTC and the SEC work together to determine whether and how the Accord should be amended. The agencies agree in principle that equity futures should be available to the marketplace. The agency staffs have agreed on many specific conditions to lifting the ban, such as authorizing the SEC to prosecute insider trading, harmonizing margin requirements, notice registration of each other's registrants, applying customer suitability rules to all intermediaries, testing personnel, establishing uniform listing standards for single-stock futures and providing SIPC coverage to customer accounts carried by securities intermediaries and segregation to customer accounts carried by futures intermediaries. We acknowledge, however, a fundamental disagreement concerning the appropriate legislative approach.

The Commission has sought to avoid creating a framework that potentially could result in overregulation of markets and intermediaries; and, therefore, the CFTC staff has advocated identifying those core provisions from each regulatory regime necessary to ensure an appropriate level of oversight for trading these products. While the agencies have agreed in principle that duplicative regulation must be avoided, the CFTC staff expressed concern that an "umbrella" approach imposing the panoply of securities regulation to these products could result in overly burdensome regulation.

The CFTC believes that it is important to bring single-stock futures to the market in a way that does not result in the government favoring one market over another. Subjecting the futures exchanges to securities laws that address public policy concerns already addressed by the CEA creates a burden that may preclude fair competition between futures and securities exchanges.

The Commission notes, however, that SEC's belief that defining equity futures products as securities is essential to fulfilling its regulatory functions. This fundamental difference in approach has led to an apparent impasse, but the agencies have nonetheless continued to try to reach a resolution.

With respect to H.R. 4541, we have no objection to the Shad-Johnson provisions as they bear on regulatory issues related to the CFTC agency oversight of single-stock futures, but the CFTC continues to recommend a regulatory structure that would allow single-stock futures to trade on both securities and futures exchanges.

Again, the Commission appreciates the opportunity to present its views. I would be happy to answer any questions you may have.

[The prepared statement of C. Robert Paul follows:]

PREPARED STATEMENT OF C. ROBERT PAUL, GENERAL COUNSEL, COMMODITY
FUTURES TRADING COMMISSION

Thank you, Chairman Oxley and members of the Subcommittee. I am pleased to appear on behalf of the Commodity Futures Trading Commission to discuss the important issues addressed in H.R. 4541.

The Commission commends the efforts of Chairman Combest, Chairman Ewing, and Congressman Stenholm to modernize the Commodity Exchange Act by introducing H.R. 4541 to provide legal certainty for over-the-counter derivatives, remove impediments to innovation, and reduce systemic risk. This bill responds to the President's Working Group's request for urgent legislative action on its recommendations so that the U.S. may retain its leadership in rapidly developing financial markets. Implementation of the Working Group's proposals is essential to enable U.S. markets to keep pace with the technological and structural changes occurring in markets around the world, and reform of the Commodity Exchange Act is a critical element of this process. The Commission recognizes the challenges involved in an undertaking of this complexity and appreciates the comprehensive approach to this task. The CFTC welcomes many of the provisions of H.R. 4541. There are, however, two areas of concern—the scope of the energy exemption and new burdens on our enforcement authority—that preclude the Commission from supporting the legislation in its current form.

The provisions of H.R. 4541 enhance legal certainty for over-the-counter derivatives by excluding from the CEA certain bilateral transactions entered into on a principal-to-principal basis by eligible parties. Legal certainty is a crucial consideration when parties to OTC derivative contracts decide with whom and where to transact business, and the President's Working Group recognized that legal certainty for OTC derivatives is vital to the continued competitiveness of U.S. markets.

The Commission supports H.R. 4541's exclusion for electronic trading facilities for OTC financial derivatives to promote an environment in which innovative systems can flourish without undue regulatory constraints. H.R. 4541 also permits clearing of OTC derivatives and authorizes a mechanism for the CFTC to regulate facilities that clear OTC derivative contracts. Again, the President's Working Group specifically recommended removing legal obstacles to the development of appropriately-regulated clearing systems to reduce systemic risk, and we support this recommendation with the following reservation. The bill would allow securities clearing systems to clear a broader range of contracts than futures clearing systems. Futures clearing facilities would have to register in a dual capacity—as futures and as securities clearing facilities—to clear the same mix of contracts available to securities clearing facilities holding a single registration. By denying futures clearing systems an equal opportunity to compete, the bill may inadvertently determine winners and losers. We urge the Committee to avoid placing futures clearing facilities at a competitive disadvantage.

The Commission also supports the bill's revision of the Treasury Amendment to make clear our jurisdiction over transactions entered into between retail customers and unregulated entities, including so-called "bucket shops." We have long sought legal clarity in this area to protect the public from foreign currency fraud, and the President's Working Group acknowledged the need for such a clarification.

H.R. 4541 would codify an exemption from most provisions of the Commodity Exchange Act for transactions in energy commodities. This is an area in which H.R. 4541 diverges from the recommendations of the President's Working Group, and the Commission believes that these provisions raise concerns that have yet to be resolved.

The Commission notes that this exemption for energy commodities, particularly as it relates to electronic trading systems that approximate exchange environments, is not governed by the same considerations that formed the basis of the Working Group's recommendations with respect to financial products. While there are some similarities between the trading of financial products and non-financial products, there are also significant differences. Most dealers in the swaps markets are financial institutions subject to supervision by bank regulatory agencies, affiliates of broker-dealers regulated by the SEC, or affiliates of FCMs subject to CFTC oversight. "Accordingly, the activities of most derivatives dealers are already subject to direct or indirect federal oversight." (PWG at 16). The same cannot be said of trading in energy derivatives. The decision to extend the exclusion in H.R. 4541 to energy derivatives would leave these OTC products in a regulatory gap—neither directly regulated as financial products nor indirectly regulated by an agency with jurisdiction over commercial participants in the energy market. Thus, a principal argument warranting the exclusion of financial derivatives from the CEA—the fact

that derivatives trading in these products is subject to direct or indirect federal oversight—does not fit OTC energy transactions.

The President's Working Group also stated that most financial OTC derivatives are not susceptible to manipulation. That case has not been made for energy products.

The CFTC has already exempted many types of energy trading from the provisions of the Commodity Exchange Act. But the exemption for energy commodities included in H.R. 4541 expands the scope of the Commission's existing exemptions for such contracts. The Commission's 1993 energy exemption is limited to those parties with the capacity to make or take delivery or the ability to contract to do so, but H.R. 4541 would extend the exemption to encompass eligible contract participants as defined in the bill, not just those acting in a commercial capacity. The 1993 energy exemption is also limited to transactions in which the material economic terms are subject to negotiation and that may not be cleared. H.R. 4541 specifically permits clearing and places no limits on standardization of contract terms. In essence, unlike the Commission's current energy exemption, H.R. 4541 would exempt transactions that may be indistinguishable from those conducted in a traditional exchange environment. It is this multilateral trading aspect of the proposed statutory exemption that gives rise to the Commission's concerns.

The Commission recognizes that under the proposed exemption, energy transactions remain subject to the CEA's antifraud and antimanipulation provisions and to such transparency rules or regulations as the Commission may impose. We support the retention of these provisions. The Commission's responsibility to police for fraud and manipulation, however, can best be carried out if the Commission is also granted the commensurate authority to promulgate regulations, where necessary, in those areas.

Last month, the Commission published in the Federal Register its comprehensive regulatory reform package, which alters fundamentally the Commission's approach to regulation of markets and participants under its jurisdiction. This proposal is based on a comprehensive evaluation of the CFTC's current regulatory structure and represents an effort to streamline that structure and to relieve domestic exchanges from unnecessary regulatory requirements. The proposal also follows the Congressional directive to transform the Commission from a frontline to an oversight regulator. The CFTC recently held two days of public meetings, with 23 witnesses representing a broad spectrum of interested parties, to maximize the input the agency receives in crafting this new framework.

H.R. 4541 attempts to codify much of the Commission's regulatory reform proposal, and we welcome the bill's support of the Commission's initiative to give registered entities the flexibility to determine the best way to structure their business and to meet their self-regulatory obligations consistent with enumerated core principles.

In administering the new flexible structure envisioned by H.R. 4541 and the Commission's regulatory reform proposal, the Commission will be moving to oversight regulation in which the agency will no longer act as a gatekeeper and will intervene only when a problem arises. To be successful in an oversight capacity, however, the Commission must be able to act quickly and effectively to address fraud and manipulation, as well as to protect the financial integrity of the markets.

Section 15 of the legislation erects several barriers to enforcement action by the Commission. When there is a violation of the core principles, the Commission must delay any action until it provides an appropriate remedy to the violator. Moreover, the bill requires that the remedy be based upon a cost/benefit analysis. Thus, the provision may allow registered entities to postpone and possibly avoid responsibility for violations of core principles by tying up the Commission in legal wrangling over whether the agency successfully met the cost/benefit test. Another consequence is that this section would essentially turn back the regulatory clock and force the agency to revert to frontline regulation and issuance of prescriptive rules.

Section 15 also shifts the burden of proof to the Commission in making a determination that a registered entity is violating a core principle. This new obligation would severely limit the Commission's ability to take appropriate remedial action outside the context of a formal enforcement proceeding. It is important for the Commission and regulated entities to be able to avail themselves of procedures designed specifically to craft regulatory changes without the burden of proof and evidentiary requirements characteristic of formal enforcement proceedings. These less formal procedures have worked well in those situations in which the Commission has found it necessary and appropriate to take remedial action involving a registered entity.

H.R. 4541 addresses the issue of equity futures contracts and reflects efforts to develop a plan to amend the Shad-Johnson Accord. The Working Group recommended that the CFTC and the SEC work together to determine whether and

how the Accord should be amended. The agencies agree in principle that equity futures should be available to the marketplace. On March 2, the two agencies presented to Congress our areas of agreement and issues that remained unresolved through that point, and on May 23, Chairman Levitt and Chairman Rainer met with Senators Lugar and Gramm to discuss the issue further. The agency staffs have agreed on many specific conditions to lifting the ban, such as harmonizing margin requirements, restricting dual trading, testing for sales and supervisory personnel, and the establishment of uniform listing standards for single stock futures. We acknowledge, however, a fundamental disagreement concerning the appropriate legislative approach.

The Commission has sought to avoid creating a framework that potentially could result in over-regulation of markets and intermediaries, and therefore the CFTC staff has advocated identifying those core provisions from each regulatory regime necessary to ensure an appropriate level of oversight for trading these products. While the agencies have agreed in principle that duplicative regulation must be avoided, the CFTC staff expressed concern that an "umbrella" approach imposing the panoply of securities regulation to these products could result in overly burdensome regulation. The CFTC believes that it is important to bring single stock futures to the market in a way that does not result in the government favoring one market over another, either by applying too light a touch or by being too heavy-handed. Subjecting the futures exchanges to securities laws that address public policy concerns already addressed by the CEA creates a burden that may preclude fair competition between futures and securities exchanges. The Commission notes, however, the SEC's belief that defining equity futures products as securities is essential to its fulfillment of its regulatory functions.

This fundamental difference in approach has led to an apparent impasse, but the agencies have nonetheless continued to try to reach a resolution. Last week, CFTC and SEC staff met twice with Treasury Department staff to focus negotiations on specific unresolved issues. We plan to continue these discussions.

With respect to H.R. 4541, we have no objection to the Shad-Johnson provisions as they bear on regulatory issues related to the CFTC's oversight of single stock futures. We wish to note, however, that we have stated from the outset of the discussion on repeal of the Accord that the CFTC believes a regulatory structure that would allow single stock futures to trade on both securities and futures exchanges is preferable to a structure that allows them to trade only on futures exchanges.

Again, the Commission appreciates the opportunity to present its views. I would be happy to answer any questions you may have.

Mr. OXLEY. Thank you, Mr. Paul.

We have had the second bell; and I guess, in deference to the members, we will suspend play here and recess the committee. The committee will stand in recess until 12:30.

[Brief recess.]

Mr. OXLEY. The subcommittee will reconvene with our apologies. Mr. Parkinson, please proceed.

STATEMENT OF PATRICK M. PARKINSON

Mr. PARKINSON. Thank you, Chairman Oxley. I am pleased to be here today to present the Federal Reserve Board's views on H.R. 4541, the Commodity Futures Modernization Act. My testimony will be quite similar to testimony that Chairman Greenspan and I presented last month to committees in the Senate and House, respectively. The Board continues to believe that such legislation modernizing the CEA is essential. To be sure, the Commodity Futures Trading Commission has recently proposed issuing regulatory exemptions that would reduce legal uncertainty about the enforceability of the over-the-counter derivatives, and would conform the regulation of the futures exchanges to the realities of today's marketplace. These administrative actions by no means obviate the need for legislation, however.

I will focus on three areas that the legislation covers: First, over-the-counter derivatives; second, regulatory relief; and third, single-

stock futures. In its November 1999 report on over-the-counter derivatives, the President's Working Group concluded that OTC transactions should be subject to the CEA only if necessary to achieve the public policy objectives of the act; that is, deterring market manipulation and protecting investors against fraud and other unfair practices.

In the case of financial derivative transactions involving professional counterparties, the Working Group concluded that regulation was unnecessary for these purposes because financial derivatives generally are not readily susceptible to manipulation and professional counterparties can protect themselves against fraud and unfair practices. Consequently, the Working Group recommended that financial over-the-counter derivative transactions between professional counterparties be excluded from the coverage of the CEA.

The provisions of H.R. 4541 that address OTC derivatives are generally consistent with the Working Group's conclusions; therefore, the Federal Reserve Board believes it would be appropriate to enact those provisions.

The Working Group did not make specific recommendations about the regulation of traditional exchange-traded futures markets. Nonetheless, it called for the CFTC to review the existing regulatory structures, particularly those applicable to financial futures, to ensure they remain appropriate in light of the objectives of the CEA. The Board supports the new approach to regulation that was outlined in proposals issued by the CFTC last month. For some time the Board has been arguing that the regulatory framework for futures trading, which was designed for the trading of grains futures by the general public, is not appropriate for the trading of financial futures by large institutions. The CFTC's proposals recognize that the current one-size-fits-all approach to regulation of futures exchanges is inappropriate, and they generally incorporate sound judgments regarding the degree of regulation needed to achieve the CEA's purposes.

Similarly, the Federal Reserve Board generally supports the regulatory relief provisions of H.R. 4541. However, the CFTC has expressed concerns that the bill unduly restricts its authority to correct violations of the core principles of regulation. To facilitate expeditious passage of legislation, it thus may be prudent to address the CFTC's concerns about its enforcement authority. The Working Group concluded that the current prohibition on single-stock futures can be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved.

The Board believes that such instruments should be allowed to trade on futures exchanges or on securities exchanges with primary regulatory authority assigned to the CFTC or the SEC, respectively. However, the SEC should have authority over some aspects of trading on these products on futures exchanges. The scope of the SEC's authority should be resolved through negotiations between the CFTC and the SEC. Whatever agreement they reach should be codified through amendments to H.R. 4541. In any event, the bill should allow securities exchanges to compete with futures exchanges in listing single-stock futures.

H.R. 4541 reflects a remarkable consensus on the need for legal certainty for OTC derivatives and regulatory relief for U.S. futures

exchanges, issues that have long eluded resolution. These provisions are vitally important to the soundness of our derivatives markets in what is an increasingly integrated and intensively competitive global economy. The Federal Reserve Board trusts the remaining differences regarding single-stock futures can be resolved quickly so that this important piece of legislation can be expedited through this Congress.

Thank you. I am pleased to answer any questions you may have. [The prepared statement of Patrick M. Parkinson follows:]

PREPARED STATEMENT OF PATRICK M. PARKINSON, ASSOCIATE DIRECTOR, DIVISION OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I am pleased to be here to present the Federal Reserve Board's views on the Commodity Futures Modernization Act of 2000 (H.R. 4541). My testimony today will be quite similar to testimony that Chairman Greenspan and I presented last month to committees in the Senate and House, respectively. The Board continues to believe that such legislation modernizing the Commodity Exchange Act (CEA) is essential. To be sure, the Commodity Futures Trading Commission (CFTC) has recently proposed issuing regulatory exemptions that would reduce legal uncertainty about the enforceability of over-the-counter (OTC) derivatives transactions and would conform the regulation of futures exchanges to the realities of today's marketplace. These administrative actions by no means obviate the need for legislation, however. The greatest legal uncertainty affecting OTC derivatives is in the area of securities-based transactions, to which the CFTC's exemptive authority does not extend. Furthermore, as events during the past few years have clearly demonstrated, regulatory exemptions carry the risk of amendment by future commissions. If our derivatives markets are to remain innovative and competitive internationally, they need the legal and regulatory certainty that only legislation can provide.

In my remarks today I shall focus on three of the areas that the legislation covers: (1) OTC derivatives; (2) regulatory relief for U.S. futures exchanges; and (3) repeal of the Shad-Johnson prohibition of single-stock futures.

OTC DERIVATIVES

In its November 1999 report, *Over-the-Counter Derivatives and the Commodity Exchange Act*, the President's Working Group on Financial Markets (PWG) concluded that OTC derivatives transactions should be subject to the CEA only if necessary to achieve the public policy objectives of the act—deterring market manipulation and protecting investors against fraud and other unfair practices. In the case of financial derivatives transactions involving professional counterparties, the PWG concluded that regulation was unnecessary for these purposes because financial derivatives generally are not readily susceptible to manipulation and because professional counterparties can protect themselves against fraud and unfair practices. Consequently, the PWG recommended that financial OTC derivatives transactions between professional counterparties be excluded from coverage of the CEA. Furthermore, it recommended that these transactions between professional counterparties be excluded even if they are executed through electronic trading systems. Finally, the PWG recommended that transactions that were otherwise excluded from the CEA should not fall within the ambit of the act simply because they are cleared. The PWG concluded that clearing should be subject to government oversight but that such oversight need not be provided by the CFTC. Instead, for many types of derivatives, oversight could be provided by the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency, the Federal Reserve, or a foreign financial regulator that the appropriate U.S. regulator determines to have satisfied its standards.

The provisions of H.R. 4541 that address OTC derivatives are generally consistent with the PWG's conclusions. At the margin, the provisions differ from those recommended by the PWG in terms of the range of counterparties covered by the exclusions. However, these differences reflect reasonable judgments regarding the types of counterparties that can protect themselves against fraud and unfair practices. Therefore, the Federal Reserve Board believes it would be appropriate to enact these provisions.

REGULATORY RELIEF FOR U.S. FUTURES EXCHANGES

The PWG did not make specific recommendations about the regulation of traditional exchange-traded futures markets that use open outcry trading or that allow trading by retail investors. Nevertheless, it called for the CFTC to review the existing regulatory structures, particularly those applicable to financial futures, to ensure that they remain appropriate in light of the objectives of the CEA. In February, the CFTC published a report by a staff task force that provided a comprehensive review of its regulatory framework and proposed sweeping changes to the existing regulatory structure. Last month the CFTC issued a revised set of proposals for public comment. With some exceptions, the regulatory relief provisions of H.R. 4541 are consistent with the CFTC's proposals.

Using the same approach as the PWG, the CFTC has evaluated the regulation of futures exchanges in light of the public policy objectives of deterring market manipulation and protecting investors. When contracts are not readily susceptible to manipulation and access to the exchange is limited to sophisticated counterparties, the CFTC has proposed alternative regulatory structures that would eliminate unnecessary regulatory burden and allow domestic exchanges to compete more effectively with exchanges abroad and with the OTC markets. More generally, the CFTC proposes to transform itself from a frontline regulator, promulgating relatively rigid rules for exchanges, to an oversight agency, assessing exchanges' compliance with more flexible core principles of regulation.

The Federal Reserve Board supports the general approach to regulation that was outlined in the CFTC's proposals. For some time the Board has been arguing that the regulatory framework for futures trading, which was designed for the trading of grain futures by the general public, is not appropriate for the trading of financial futures by large institutions. The CFTC's proposals recognize that the current "one-size-fits-all" approach to regulation of futures exchanges is inappropriate, and they generally incorporate sound judgments regarding the degree of regulation needed to achieve the CEA's purposes.

Similarly, the Federal Reserve Board generally supports the regulatory relief provisions of H.R. 4541. However, the CFTC has expressed concerns that the bill unduly restricts its authority to correct violations of the core principles of regulation. To facilitate expeditious passage of legislation, it thus may be prudent to address the CFTC's concerns about its enforcement authority.

SINGLE-STOCK FUTURES

The PWG concluded that the current prohibition on single-stock futures (part of the Shad-Johnson Accord) can be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved. The Board believes that such instruments should be allowed to trade on futures exchanges or on securities exchanges, with primary regulatory authority assigned to the CFTC or the SEC, respectively. However, the SEC should have authority over some aspects of trading of these products on futures exchanges. The scope of the SEC's authority can and should be resolved through negotiations between the CFTC and the SEC. The Congress should continue to urge the two agencies to settle their remaining differences. Whatever agreement they reach should then be incorporated through amendments to H.R. 4541. In any event, the bill should allow securities exchanges to compete with futures exchanges in listing single-stock futures.

If it would facilitate repeal of the prohibition, the Federal Reserve Board is willing to accept regulatory authority over levels of margin on single-stock futures, as provided in H.R. 4541, so long as the Board can delegate that authority to the CFTC, the SEC, or an Intermarket Margin Board consisting of representatives of the three agencies. The Board understands that the purpose of such authority would be to preserve the financial integrity of the contract market and thereby prevent systemic risk and to ensure that levels of margins on single-stock futures and options are consistent. The Board would note that, for purposes of preserving financial integrity and preventing systemic risk, margin levels on futures and options should be considered consistent, even if they are not identical, if they provide similar levels of protection against defaults by counterparties, taking into account any differences in (1) the price volatility of the contracts, (2) the frequency with which margin calls are made, or (3) the period of time within which margin calls must be met.

CONCLUSION

H.R. 4541 reflects a remarkable consensus on the need for legal certainty for OTC derivatives and regulatory relief for U.S. futures exchanges, issues that have long eluded resolution. These provisions are vitally important to the soundness and com-

petitiveness of our derivatives markets in what is an increasingly integrated and intensely competitive global economy. The Federal Reserve Board trusts that the remaining differences regarding single-stock futures can be resolved quickly, so that this important piece of legislation can be expedited through this Congress.

Mr. OXLEY. Thank you, Mr. Parkinson.
Mr. Sachs.

STATEMENT OF LEWIS A. SACHS

Mr. SACHS. Thank you, Mr. Chairman, and members of the subcommittee. I appreciate the opportunity to appear before you today to discuss H.R. 4541, the Commodity Futures Modernization Act of 2000.

Mr. Chairman, the OTC derivatives markets provide a number of benefits to our economy, enhancing the ability of businesses to manage their risk profiles, to compete more effectively in the global marketplace and to deliver more efficiently and at lower cost a wide range of products and services to the American consumer. It was with this in mind that last year the President's Working Group on Financial Markets, chaired by the Secretary of the Treasury, was requested to conduct a study of the OTC derivatives markets and the Commodity Exchange Act.

In response, the Working Group developed a set of unanimous recommendations designed to reduce systemic risk, promote innovation, protect retail customers, maintain U.S. competitiveness in these markets and protect the integrity of the underlying markets. We believe that it is important to move forward with appropriate legislation designed to accomplish these important objectives as soon as possible. The legislation before you today largely incorporates the recommendations of the Working Group with respect to OTC derivatives, and we support enactment of these provisions.

Let me touch upon a few of the specific objectives that the bill addresses. First, H.R. 4541 would provide legal certainty. With regard to swap agreements, the Working Group sought to address an area in which the need for change had been clearly demonstrated. The Commodity Exchange Act was designed to address issues of fraud, manipulation and price discovery. Therefore, the Working Group unanimously recommended clarifying the legal status of these instruments by creating a statutory exclusion from the CEA only for transactions among large sophisticated parties involving instruments not readily susceptible to manipulation and that do not currently serve a price discovery function. This bill would establish such an exclusion and would permit the electronic trading of these instruments, and we are supportive of these provisions.

Second, this bill would provide for the development of appropriately regulated clearinghouses. Well-designed clearinghouses can help to reduce systemic risk. Consistent with the Working Group's recommendation, the bill provides for the development of clearinghouses through clarification of their legal status and also requires that they be regulated. We believe these provisions can make an important contribution toward mitigating systemic risk.

Finally, this legislation takes an important step toward protecting retail customers by providing the CFTC with explicit authority to regulate foreign currency bucket shops. We are pleased that the provisions have been included in this bill.

Let me discuss the bill's provisions relating to the reform of the Shad-Johnson Accord. We believe, as the Working Group report states and has been quoted several times here today, that the current prohibition on single-stock and narrow based-stock index futures can be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved. There are a number of concerns, however, that the regulatory agencies consider important that have not yet been resolved.

As we have stated, it is important for the SEC and CFTC to jointly address these issues. We are committed to making every effort to facilitate progress in resolving these issues. However, if these issues cannot be resolved on a timely basis, we believe that it is important to move forward with legislation designed to clarify the legal certainty for OTC derivatives and to implement the other recommendations of the Working Group.

Turning finally to the bill's provisions regarding regulatory relief for futures exchanges, we continue to support the view that it is appropriate to review from time to time existing regulatory structures to determine whether they continue to serve valid public policy functions. Broadly, we are supportive of the CFTC efforts to provide appropriate regulatory relief to the futures exchanges. We recognize the need for competitive parity between the exchanges and off-exchange markets, particularly as the status of off-exchange markets is clarified.

Before concluding, Mr. Chairman, let me touch upon one issue that is not part of the bill before you today but which is related and vitally important to the smooth functioning of our markets during periods of volatility. I would like to take this opportunity to strongly urge Congress to adopt the Working Group recommendations regarding the treatment of OTC derivatives and certain other financial contracts in cases of bankruptcy or insolvency. Rarely are there tangible steps the government can take that can have a meaningful impact on the mitigation of systemic risk, and this is one such opportunity.

In conclusion, Mr. Chairman, we have an opportunity to advance legislation that will create a modern legal and regulatory framework for OTC derivatives. We look forward to working with you and the other members of this committee and our colleagues of the Working Group to advance these important objectives.

That concludes my opening remarks. I would be happy to answer any questions and ask that my prepared remarks be submitted for the record.

[The prepared statement of Lewis A. Sachs follows:]

PREPARED STATEMENT OF LEWIS A. SACHS, ASSISTANT SECRETARY, DEPARTMENT OF
TREASURY

Chairman Oxley, Ranking Member Towns, members of this Subcommittee, I appreciate the opportunity to appear before you today to discuss H.R. 4541, the Commodity Futures Modernization Act of 2000.

In November 1999, the President's Working Group on Financial Markets presented its report *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* to the Congress. In this report, the Working Group, which is chaired by Secretary Summers and includes the Chairmen of the Federal Reserve, the Commodity Futures Trading Commission and the Securities and Exchange Commission, set forth a series of unanimous recommendations designed to reform the legal and

regulatory framework affecting the OTC derivatives market. The legislation before you today would enact many of those important recommendations.

I would like to begin by providing some background on OTC derivatives and the recommendations of the President's Working Group on Financial Markets. I will then turn to H.R. 4541 more specifically, including the bill's treatment of OTC derivatives, regulatory relief for the futures exchanges, and the reform of the Shad-Johnson restrictions on the trading of single stock and narrow-based stock index futures.

I. OTC DERIVATIVES AND THE PRESIDENT'S WORKING GROUP'S RECOMMENDATIONS

Mr. Chairman, our financial sector is the central nervous system of the American economy. As our economy and our financial markets have evolved over the past two decades, so too have the needs of the financial sector. Most notably, in an era of globalization, volatility of interest rates, increased securitization and the growth of the bond markets relative to the traditional loan markets, businesses and financial institutions have required a more diverse and effective set of tools for managing risk.

In that sense, the over-the-counter derivatives market has grown directly in response to the needs of the private sector. An OTC derivative is an instrument that allows a party seeking to reduce its risk exposure to transfer that exposure to a counterparty that wants and may be in a better position to assume the risk. This is an important development that has significantly enhanced the ability of businesses to manage their risk profiles, to compete more effectively in the global marketplace, and to deliver more efficiently and at lower cost a wide range of services and products to the American consumer.

Because of these rising demands, the notional value of global OTC derivatives has risen more than five-fold over the past decade, to more than \$80 trillion according to estimates produced by the Bank for International Settlements.

The benefits to the American economy of OTC derivatives would continue to grow within a proper and appropriate framework of legal certainty. For example:

- By helping businesses and financial institutions to hedge their risks more efficiently, OTC derivatives enable them to pass on the benefits of lower product costs to American consumers and businesses.
- By allowing for the transfer of unwanted risk, OTC derivatives promote the more efficient allocation of capital across the economy, further increasing American productivity.
- By providing better pricing information, OTC derivatives can help promote greater efficiency and liquidity of the underlying cash markets that feed into a stronger economy for all Americans.
- And, by enabling more sophisticated management of assets, including mortgages, consumer loans and corporate debt, OTC derivatives can help lower mortgage payments, insurance premiums, and other financing costs for American consumers and businesses.

Thus, OTC derivatives have the potential to bring important benefits to our economy. It was with the importance of OTC derivatives in mind that, last year, the Congress requested that the Working Group conduct a study of the OTC derivatives market and recommend changes required to ensure that we continue to reap such benefits.

In response, the Working Group developed its set of unanimous recommendations designed to achieve four objectives:

- **First, to reduce systemic risk** in the OTC derivatives market by removing legal impediments to the development of clearing systems and ensuring that those systems are appropriately regulated.
- **Second, to promote innovation** in the OTC derivatives market by providing legal certainty for OTC derivatives and electronic trading systems. This would strengthen the overall legal framework governing the OTC derivatives market and, in turn, would stimulate greater competition, transparency, liquidity, and efficiency and deliver stronger benefits to US consumers and businesses.
- **Third, to protect retail customers** by ensuring that appropriate regulations are in place to deter unfair practices in all markets in which they participate and by closing existing legal loopholes that allow unregulated entities to pursue such unfair practices through foreign currency transactions.
- **And fourth, to maintain US competitiveness** by providing a modernized framework that will lead those engaged in the financial services industry to continue the operations of their businesses in the United States, and thereby promote the continued leadership of American capital markets.

Given the scope of the bill before you today—providing legal certainty to OTC derivatives, reforming the Shad-Johnson Accord, and providing regulatory relief for futures exchanges—today I would add a fifth important objective:

- **To protect the integrity of the markets** underlying the derivatives in question—in particular, the securities markets.

While seeking to accomplish these objectives, we need to recall that the emergence of the OTC derivatives market has come during an era of unprecedented economic strength and prosperity.

It is to be expected that in times of distress some participants in these markets, as in other financial markets, will be adversely affected. The recommendations we have made, and the provisions in this bill, will not prevent these situations from occurring, nor are they intended to do so. What needs to be protected, however, is the financial system as a whole, and not individual institutions.

We believe that our recommendations with respect to clearing and those designed to enhance transparency and legal certainty and to clarify the treatment of derivatives in the case of bankruptcy or insolvency can contribute to enhancing the stability of the system more broadly.

II. THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

Let me now turn to the legislation before you today, H.R. 4541. Mr. Chairman, we believe that this bill incorporates many of the recommendations of the Working Group with respect to OTC derivatives which, if enacted, would promote greater legal certainty for these instruments and help to advance the Working Group's other objectives. In particular, with respect to legal certainty, we believe that this bill, with minor changes, would strike the appropriate balance between allowing the economy to realize more fully the benefits of derivatives and, at the same time, ensuring the integrity of the underlying markets, providing appropriate protection for retail customers, and where possible, taking steps to mitigate systemic risk.

Moreover, we believe that it is important to move forward with appropriate legislation as soon as possible. A failure to act in this area would risk a situation in which the existing legal framework for our financial markets would lag significantly behind the development of the markets themselves.

In the absence of an updated legal and regulatory environment, needless systemic risk might jeopardize the broader vitality of the American capital markets; innovation might be stifled by the absence of legal certainty; and American consumers might be deprived of the benefits that a more appropriate legal framework would promote. We also risk an erosion of the competitiveness of American financial markets, with an increasing amount of business moving offshore to jurisdictions in which the regulatory framework has kept up with the pace of change.

With this in mind, I would like to address the three major areas of the bill:

- First, the bill's approach to OTC derivatives;
- Second, the provisions of the bill designed to provide regulatory relief for futures exchanges; and
- Finally, the provisions of the bill providing for the repeal of the Shad-Johnson restrictions on the trading of single stock and narrow-based stock index futures.

OTC Derivatives

Let me first discuss the bill's provisions regarding OTC derivatives. H.R. 4541 would take significant steps toward achieving the Working Group's goals by enacting most of our recommendations regarding OTC derivatives. While there are a few changes which we would like to see enacted, such as amendments to the definition of eligible contract participants and of excluded commodity, we believe that the legislation takes an appropriate approach to OTC derivatives and encourage the Congress to adopt these provisions. Let me touch upon a few of the specific objectives that this bill helps to accomplish.

First, H.R. 4541 would provide legal certainty. The Working Group members spent several months studying and developing recommendations regarding the appropriate status of OTC derivatives under the Commodity Exchange Act. We focused upon areas in which the need for change had been demonstrated in our markets.

With regard to swap agreements, the Working Group sought to remove the cloud of legal uncertainty resulting from questions about the enforceability of certain swap contracts in U.S. courts. This uncertainty resulted from a lack of clarity regarding whether the CEA applies to certain OTC derivative transactions. The CEA was designed primarily to address issues of fraud, manipulation, and price discovery. Thus, the Working Group unanimously recommended that the legal status of such contracts be clarified by creating a statutory exclusion from the CEA for certain OTC derivative transactions which do not require regulation for these public policy rea-

sons. The exclusion is limited to transactions involving qualified participants who do not require the additional protections of the CEA, and the instruments subject to the exclusion generally are not susceptible to manipulation, nor do they serve a primary price discovery function at this time.

H.R. 4541 would establish such an exclusion for certain swap agreements and thereby ensure that the U.S. OTC derivatives market can develop within the kind of innovative and legally stable environment on which the continued competitiveness of our financial markets depend.

Second, H.R. 4541 would provide for the development of appropriately-regulated clearinghouses. The Working Group's report recommended that Congress enact legislation to provide a clear basis for the development of appropriately-regulated clearing systems for OTC derivatives. Well-designed clearinghouses can help to reduce systemic risk: first, by diminishing the likelihood that the failure of a single market participant can have a disproportionate effect on the market as a whole; and second, by facilitating the offsetting and netting of contract obligations. In addition to these benefits, however, clearing tends to concentrate risks and certain responsibilities for risk management in a central counterparty or clearinghouse. Therefore, appropriate regulation of clearing systems is essential to ensure that they indeed serve to mitigate systemic risk.

Under the Working Group framework, regulatory oversight could be provided by the CFTC, SEC, a federal banking regulator, or by a recognized foreign regulatory authority, depending on the structure of the clearinghouse and its activities.

H.R. 4541 provides for the development of clearinghouses, and requires that they be regulated. It thereby can provide the beneficial effects of reducing systemic risk by encouraging the development of such systems through the clarification of their legal status and by subjecting them to appropriate supervision.

However, we believe that H.R. 4541 could be improved by clarifying the scope of the SEC's authority to regulate clearinghouses that clear securities and that also wish to clear OTC derivatives.

Finally, H.R. 4541 takes important steps toward protecting retail customers. The Working Group recommended that the CFTC be granted explicit authority to regulate foreign currency "bucket shops" and to prosecute such entities when they attempt to defraud retail customers. H.R. 4541 provides such authority to the CFTC, thus strengthening protection for small investors. Again, this is an area in which problems have arisen, and the need for appropriate oversight clearly has been demonstrated. We are pleased to see these provisions incorporated in the bill.

The Shad-Johnson Accord

Let me now turn to the section of the bill addressing reform of the Shad-Johnson Accord. The members of the Working Group agreed that the current prohibition on single-stock and narrow-based stock index futures could be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved. Our view remains unchanged.

The provisions contained in this bill regarding futures on non-exempt securities are a good starting point, although a number of issues remain unresolved. The bill addresses some of the customer protection and enforcement concerns identified by the CFTC, the SEC, and others as necessary conditions for repealing the prohibition on single-stock futures. However, there are a number of concerns that the regulatory agencies consider important, but that have not been resolved in the legislation. We hope that the SEC and CFTC can provide specific comments on these issues in the near future so that they can be incorporated into this bill.

In particular, certain issues related to the harmonization of margin requirements will need to be clarified. While we do not see the need to establish margin requirements in statute, it will be important for regulatory authorities to establish margin levels that do not encourage regulatory arbitrage or lead to a substantial increase in leverage in our financial system.

While we have no objection to the introduction of single-stock or narrow-based stock index futures, it is vitally important that the integrity of the underlying markets be preserved, and that these instruments not be used as a means to avoid the regulations of the cash markets. Therefore, we continue to encourage efforts by the SEC and CFTC to reach an agreement on a regulatory framework for these products that preserves the integrity of the underlying securities markets. However, if these issues cannot be resolved on a timely basis, we believe that it is important to move forward with legislation designed to clarify the legal certainty for OTC derivatives and to implement the other recommendations of the Working Group.

Regulatory Relief

The third component of this bill addresses regulatory relief for the futures exchanges. The Treasury Department continues to support the view that it is appropriate to review, from time to time, existing regulatory structures to determine whether they continue to serve valid public policy functions. Like the OTC markets, exchange trading of derivatives should not be subject to regulations that do not have a public policy justification. Broadly, we are supportive of the CFTC's efforts to provide appropriate regulatory relief to the futures exchanges, consistent with the public interest. To this end, the CFTC has recently released its regulatory relief proposal for public comment. We will be submitting a formal comment letter on this proposal in the near future.

There may, however, be unforeseen consequences to *legislating* such regulatory relief. Once such provisions are written into law, the regulators will have no ability to review and amend them should subsequent market developments warrant change or should other problems arise. Again, we are supportive of appropriate regulatory relief for futures exchanges, but suggest that certain aspects of that relief may be more appropriately provided through administrative action.

III. THE IMPORTANCE OF CLARIFYING THE TREATMENT OF FINANCIAL CONTRACTS IN BANKRUPTCY

Mr. Chairman, although not part of this bill, I would like to take this opportunity to strongly urge Congress to adopt the President's Working Group recommendations regarding the treatment of OTC derivatives and certain other financial contracts in cases of bankruptcy or insolvency. Rarely are there tangible steps the government can take that could have a meaningful impact on the mitigation of systemic risk. Enacting the recommendations of the Working Group designed to clarify the treatment of these instruments in bankruptcy is one of those steps. By establishing a framework through which creditors and counterparties can work out a swift resolution in cases of bankruptcy or insolvency, enactment of these recommendations can serve to reduce the impact of the failure of any one institution on the stability of the system more broadly.

IV. CONCLUSION

In conclusion, Mr. Chairman, we have an opportunity to advance legislation that will create a modern legal and regulatory framework for OTC derivatives designed to promote innovation, protect retail customers, reduce systemic risk, maintain U.S. competitiveness, and ensure the integrity of our markets. We look forward to working with the members of this Committee, other members of Congress, and our colleagues on the President's Working Group in an effort to further advance these important objectives.

Thank you.

Mr. OXLEY. Thank you, Mr. Sachs. Let me begin my 5 minutes with Mr. Parkinson. The provisions on legal certainty in the legislation, does that really solve all of the legal certainty problems that OTC markets now face?

Mr. PARKINSON. I think it solves the most significant legal certainty problems; that is, those relating to eligible participants, that is, institutions and wealthy individuals use of securities-based derivatives, electronic trading systems—other than perhaps those for agricultural products—and clearing facilities. What it leaves unresolved is whether the CEA applies to retail swap transactions, but I would note that we don't believe that there is a significant amount of retail activity at this time that is being imperiled by that uncertainty.

Mr. OXLEY. Do the margin provisions in the bill adequately address concerns about consistent margins on single-stock futures and options?

Mr. PARKINSON. Yes, in the sense that the bill empowers the Federal Reserve to ensure that margins are consistent, and it makes clear what is meant by consistency in this context. I think we do have some technical comments regarding the provisions that

define what consistency means, which I think would be the major source of potential confusion and conflict. But yes, I think in that sense it does provide a solution.

Mr. OXLEY. Let me ask Mr. Paul, what is the overlap between your regulatory relief proposal and this bill?

Mr. PAUL. Congressman, the bill attempts to codify very much of our regulatory relief proposal as published in the Federal Reserve last June. However, our proposal is out for public comment, and the comment period extends until August 7. We anticipate getting comments in response to those, perhaps making further refinements in our proposal, but we believe that the codification put forth in the legislation is fundamentally close with our proposal and we would expect where our proposal ends up that we would support the legislation and would look forward to working with congressional staffs to fine-tune any adjustments that would be required so that our regulatory proposal would match up with the codification.

Mr. OXLEY. You heard some criticism from the dais earlier about shifting from a front-line regulator to an oversight role. First of all, your comments; and second, how would it impact this legislation?

Mr. PAUL. I will answer the second question first.

One way that it would impact, as I suggested in my remarks, my opening remarks, is that because we are moving from prescriptive rules to general core principles, we believe it is more important than ever that we have enforcement authority that we can exercise quickly and effectively. And we are concerned with the form of the legislation currently, that may delay and hamstring us in administering or taking quick and decisive enforcement action. So we believe that if we modify that provision in the legislation, we would be in a position to continue with our current enforcement efforts, and I guess in connection with some of the comments made earlier I just want to make the point that we believe that in our 25-year history we have a very effective record of meaningful and diligent enforcement in protecting the futures markets, both for institutional as well as retail investors.

Mr. OXLEY. Mr. Sachs, what has been the Treasury's role in facilitating agreement between the SEC and CFTC on the regulation of single-stock futures?

Mr. SACHS. Mr. Chairman, we have only in recent weeks been asked to see if we can help facilitate those discussions. The CFTC and SEC have had an extensive period of discussion on Shad-Johnson to see if they could resolve the remaining issues. We have held several meetings. We have another one I believe this afternoon, to see if we can't move the process along further, to make clear to everyone where there is agreement and where there is disagreement and to see if we might not be able to help bridge that gap.

Mr. OXLEY. Is it possible for CFTC and the SEC, with your help, to reach an agreement before we start to mark up this vehicle?

Mr. SACHS. I don't know the answer to that yet, Mr. Chairman. It is still early in our involvement. The issues are, as everyone has stated, quite complicated. The two different approaches that the different agencies take to the way that they regulate their own markets are quite different. We are going to make every effort to

try to get this done on a timely basis to be helpful to your committee. But I can't provide any guarantees.

Mr. OXLEY. This is somewhat similar to operating subsidiaries during the last session. I hate to reopen old wounds, but it struck me as there are some similarities here. Other than the CFTC, who I am sure watched from afar with fascination, but as far as the role of the Fed and the Treasury and ultimately getting an agreement from Mount Olympus on op subs which allowed us to go forward and pass historic legislation, and perhaps Mr. Sachs we can make history one more time in that regard.

Mr. SACHS. I hope to be able to come back in a few weeks and say that everyone was able to learn from the experience of last year and push this along. I can only—we will be happy to report to you every several days.

Mr. OXLEY. We appreciate your working with our staff. As I say, we are under a severe time constraint and we want to make every effort to try to craft legislation. We appreciate your participation, all of your participation.

The gentleman from Staten Island.

Mr. FOSSELLA. Thank you, Mr. Chairman. Just a brief question for all members of the panel. Do you have any concern whatsoever—some opponents of the bill have raised concern about its impact on the margins and potential for insider trading and a concern that there will be manipulation of stock. Do you have any opinion on that? And if so, I would like to hear it.

Mr. PAUL. Let me take the first crack in answering that, Congressman.

From the very beginning in our negotiations with the SEC, the CFTC has recognized the importance of harmonizing margins between the two markets. We have discussed a number of approaches to that with the SEC. We are in general agreement that the margins should be harmonized. Whether we do that with the intervention of the Federal Reserve Board or whether we do it just between our two agencies, we think either way would work and we would be willing to take either approach.

With respect to insider trading, we have acknowledged and are in full agreement with the SEC that it is absolutely essential that any trading of single-stock futures or narrow-based indices on the futures side would not provide a vehicle to circumvent the securities laws and the protections that currently exist. That is why we have advocated and continue to support that the SEC be given authority to prosecute insider trading wherever it takes place, whether it be on the securities or futures side. We think that the bill does that, but we are interested in continuing to work with the SEC on any ways that we can make that stronger and make that clearer.

So I actually think that both agencies are in nearly full agreement on both those issues.

I will just add one other thing which has come up throughout the conversation today, and that is customer suitability. We also agree with the SEC for the need for customer suitability on the futures side. We agree that to the extent that any futures registrants should be trading these products, they should be subject to customer suitability rules on the futures side equivalent to the rules on the securities side.

Mr. FOSSELLA. When was the last time you met with the SEC?

Mr. PAUL. On this matter was last Friday, and we are scheduled to meet again this afternoon, which we may be postponing until tomorrow based on running over today. We continue to move closer to full agreement.

Mr. PARKINSON. On the margin issue, I think this is being painted as much more difficult than it actually is. We hear again and again that the margin for single stocks in the security markets is 50 percent and that margins in the futures markets are 5 percent. In a sense, but only in a very misleading sense, that is true. The 50 percent margin is the initial margin on an individual stock. The 5 percent margin or 5.5 percent margin is the maintenance margin on a stock index. Maintenance margins in the securities markets are 25 percent, not 50 percent. Furthermore, if one used the same methodology that the Chicago exchanges use in coming up with their 5.5 percent on a stock index product, that would translate into a significantly higher margin for a single stock. I think, depending on the volatility of the individual stock, that could be anywhere from 10 percent to 30 percent, with the 10 percent applying to the lower volatility high-cap stocks, and the 30 percent applying to the truly speculative issues of thinly capitalized firms.

Thus, I think framing the issue on terms of 50 percent versus 5 percent makes it look like the differences between the margining systems used in the futures markets and the margining systems that are in place in securities markets are much greater than they in fact are.

Mr. SACHS. I have nothing further to add to either of these comments.

Mr. FOSSELLA. Mr. Sachs, are you concerned at all, or Mr. Parkinson, that there may be a competitive disadvantage between the exchanges?

Mr. SACHS. With respect to single-stock futures?

Mr. FOSSELLA. Yes.

Mr. SACHS. Well, we hope that—we think that it is possible to craft the legislation such that those advantages would not be—so that there wouldn't be those advantages and disadvantages. I think if we can all come to agreement on how these instruments should be regulated, that there would not be meaningful differences such that one set of exchanges would have an advantage over the other. And that is actually something that we need to keep in mind as we work on this agreement and as you consider the legislation.

Mr. PARKINSON. One obvious point, the H.R. 4541 allows single-stock futures to be traded on futures exchanges, but does not permit securities exchanges to trade them, so that obviously is a severe competitive imbalance. I think we have urged, and I believe Bob has urged, that as this legislation moves forward, it should be modified so if we have trading of single-stock futures, as everyone is urging, that stock exchanges and futures exchanges be able to compete in listing the products.

Mr. FOSSELLA. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired. The gentleman from New York, Mr. Towns.

Mr. TOWNS. Mr. Chairman, I am certain that every question has been asked and every answer has been given. I think that what I

would basically say is that I look forward to working with you to try and resolve some of the problems that exist, and I think that working together we can come up with a solution and be able to move something forward.

I think that the time to do it is now. We don't have a big turnaround time, but the point is if we work hard in some of the areas, I think we can come up with a compromise. I look forward to working with you and of course, Mr. Chairman, working with you and trying to resolve those issues to be able to move this legislation forward.

On that note I yield back the balance of my time.

Mr. OXLEY. I thank the gentleman for his comments. Indeed, I share them as well. We want to thank all of you. This committee does not want to stand in the way of the SEC and the CFTC meeting during this critical period of time. In that regard I would ask unanimous consent that all opening statements be made part of the record and the subcommittee stands adjourned.

[Whereupon, at 12:57 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

PREPARED STATEMENT OF BOARD OF TRADE OF THE CITY OF CHICAGO

The Chicago Board of Trade is pleased to submit for the record this testimony on H.R. 4541. We strongly endorse this vital legislation. We appreciate this Subcommittee's interest in the issues addressed in H.R. 4541 and welcome the opportunity to summarize for you our views on the legislation.

All commerce involves price risk. Futures markets help to address that price risk by offering a vehicle for shifting those risks to others or identifying a going market rate. For many decades, agricultural futures contracts traded on U.S. futures exchanges were the only organized, centralized markets for managing price risk. Since 1975, that list of commodities has expanded to include precious metals, petroleum products, foreign currency and interest rates. In 1982, the list was expanded again to include stock indexes like the Dow Jones Industrial Average. All of those markets are regulated under the Commodity Exchange Act, a statute administered since 1975 by the Commodity Futures Trading Commission.

In the last fifteen years this landscape has changed. Financial engineers on Wall Street have invented swaps and other derivatives to replicate the risk-shifting benefits of futures trading. Swaps have become enormously popular and profitable, offering tailored, customized risk-shifting service to most facets of our economy. Swaps are traded on interest rates, currency rates, commodity prices and equity securities. Today, swaps are even offered in more standardized versions on electronic trading platforms. And, swap transactions are not subject to any form of regulation that even approaches the regulation of futures or securities markets.

This development triggered or exacerbated three problems.

First, the Commodity Exchange Act covers all futures contracts. All futures must be traded on CFTC-regulated exchanges, absent an exemption. If a swap is a futures contract, it is illegal and voidable by either party to the transaction. As a result, swaps today are said to operate under a cloud of legal uncertainty caused by the perceived lack of specificity in the Commodity Exchange Act's coverage.

Second, as the President's Working Group observed last year, the development and maturation of the swaps market has blurred many of the traditional ways that swaps were distinguished from futures contracts. Since swaps are largely unregulated and futures are heavily regulated, the Working Group unanimously agreed that something should be done to rectify that competitive disparity without imposing additional burdens on swaps.

Third, despite the current legal uncertainty, equity swaps are being offered on single equity securities. In 1982, however, Congress adopted what is known as the Shad-Johnson Accord and imposed what it thought was a "temporary" moratorium on trading in futures on single equity securities. (The moratorium was to be temporary while the SEC and CFTC figured out the best way to regulate single stock futures. Congress is still awaiting that joint recommendation some 18 years later.) If equity swaps are futures, they too are subject to that "temporary" ban. If swaps are not futures, then the futures exchanges simply need to start offering equity

swaps to avoid the ban. Since figuring out what transactions are futures and what transactions are not has stymied Congress, the courts and commentators for many years, the President's Working Group recommended last year finding a way to simply lift the ban while addressing any major market integrity issues.

H.R. 4541 attempts to resolve each of these three challenges. It does so by promoting fair competition to strengthen U.S. markets while minimizing, but not eliminating, regulatory arbitrage. It treats the competitive interests of the swaps dealers, futures exchanges and options exchanges in a fair and even-handed manner. It recognizes and tries to anticipate the role of technology in the markets of the future. And it preserves important public and market integrity protections. H.R. 4541 is comprehensive, balanced and responsible.

First, H.R. 4541 attempts to address the legal uncertainty issue by creating bright-line tests defining what transactions are subject to the CEA and what are not. The lines drawn are basically adapted from last year's President's Working Group Report. Any transactions in financial commodities, called excluded commodities, not on a physical trading facility are excluded from the CEA unless they involve a retail customer. Special rules apply to these transactions when traded on electronic trading facilities. In that context, the CEA does not apply to trades that meet two tests: trades must be principal to principal (not on behalf of customers) and limited only to sophisticated counterparties or institutions. Excluded transactions may be subject to clearing arrangements and still be excluded from regulation.

As a result of these provisions, many futures contracts traded today on CFTC-regulated exchanges, including futures on currencies, Eurodollars and stock indexes, could be offered without any form of regulation, even if traded on the same centralized electronic systems the futures exchanges use. This regulatory arbitrage is even more pronounced when one considers that over 95% of the market participants in exchange-traded futures today are the same professional, sophisticated counterparties that are eligible to trade in the excluded futures. The net result of these provisions: same contracts, same customers, same trading system, but very different regulatory treatment.

H.R. 4541's second prong attempts to minimize this regulatory arbitrage by modernizing the regulatory burdens imposed on exchanges. Instead of current law's innumerable rigid mandates that promote government micromanagement, H.R. 4541 requires exchanges to meet flexible performance standards, subject to the CFTC's oversight, in order to discharge their self-regulatory obligations. Exchanges could tailor their systems for compliance with specific self-regulatory requirements to the needs of different markets, rather than the current "one size fits all" brand of regulation. On balance, the message of H.R. 4541 to the futures exchanges is this—Congress will not shackle your over-the-counter competition; it wants you to compete with them and is willing to give you many of the tools *you believe you need* to compete effectively on a fair, if not completely level, playing field.

The third prong of H.R. 4541 involves a similar message in the area of equity-based derivatives. The 1982 ban on single stock futures would be lifted subject to special regulatory requirements that are designed to accommodate the areas of concern expressed by the Securities and Exchange Commission, and others. Specifically, single stock futures must be: 1) cash-settled; 2) not susceptible to manipulation; 3) traded at margin levels that are consistent with *stock* options margins; 4) traded only on stocks that meet SEC eligibility requirements for stock options; 5) traded without dual trading brokers; and 6) offered only on exchanges that agree to provide the SEC such information as the SEC and CFTC jointly consider to be necessary for the SEC to carry out its enforcement powers. Under those enforcement powers, the SEC is free to bring actions to enforce core securities law protections in connection with single stock futures trading: insider trading, short swing profits, manipulation, front-running, tender offer pricing and integrity and trading in restricted securities. The SEC would be able to bring these actions unilaterally without seeking cooperation or concurrence from the CFTC.

In addition, margins for single stock futures would ultimately be set and supervised by the Federal Reserve Board or an Intermarket Margin Board where the SEC and CFTC would have an equal voice. And the futures industry-wide self-regulatory body, the National Futures Association, would adopt and enforce a special suitability rule for any futures professional that recommended a single stock futures trade to a customer. NFA must consult with the SEC and CFTC, and obtain CFTC approval of this rule, within 9 months of the date of enactment.

H.R. 4541 responds to the three critical issues that the General Accounting Office, in its April 2000 report, identified for single stock futures—insider trading, margin and suitability—by, *in effect*, incorporating securities *law concepts* into the futures regulatory apparatus. Through these special provisions, H.R. 4541 addresses the

major areas of possible regulatory arbitrage between futures exchanges and options exchanges. As in the area of off-exchange and on-exchange futures trading described earlier, the bill minimizes, but does not eliminate entirely, regulatory arbitrage. Instead, H.R. 4541 promotes competition by finally allowing the futures exchanges to offer equity-based derivatives that swaps dealers and options exchanges now may offer *in other guises*.

Mr. Chairman, many observers believe that U.S. futures exchanges are falling behind their competition both overseas and over-the-counter. Today, the Swiss-German electronic exchange, called EUREX, has replaced the Chicago Board of Trade as the futures exchange with the highest trading volume. To address these threats, the Board of Trade is restructuring and reorganizing its business operations to maximize our chances of capturing the benefits of new technology and innovations. We know we are in for a fight and we are willing to compete. Rationalizing regulation and removing competitive barriers imposed by statute, as contemplated by H.R. 4541, are critical elements in our competitive battle.

For these reasons, the Chicago Board of Trade strongly endorses H.R. 4541. It tackles the difficult challenges of *modern markets* in a pro-competitive manner without sacrificing important regulatory interests. We urge you to join the House Agriculture Committee by giving H.R. 4541 favorable treatment in this Subcommittee and the Full Committee. We look forward to working with you as your deliberations progress.

PREPARED STATEMENT OF SCOTT GORDON, CHAIRMAN, BOARD OF DIRECTORS,
CHICAGO MERCANTILE EXCHANGE

Chairman Oxley, members of the Subcommittee, I am Scott Gordon, Chairman of the Board of Directors of the Chicago Mercantile Exchange (CME). The CME welcomes the opportunity to provide this testimony for the record. More than a year ago, on May 19, 1999, the Exchange appeared before the Risk Management Subcommittee of the Agriculture Committee to offer its view of the reauthorization process and the important issues facing the industry and the Commission. Even at that early stage of the process, the CME and the Chicago Board of Trade had taken the lead and proposed a legislative framework for rationalizing the regulation of derivatives markets.

The CME and CBOT were joined by the New York Mercantile Exchange in our effort to craft amendments to the Commodity Exchange Act to enhance competition and customer opportunity. We proposed five principles and a long list of detailed proposals. We proposed a means to rationalize the CEA and to restore internal consistency in concert with sound public policy. Within our framework, each segment of the industry, other than securities exchanges, which seek protection from legitimate competition, got exactly what it had been publicly seeking. Our proposal went farther than the OTC request for codification of the swaps exemption. We proposed that swaps could be cleared without losing their exemption. We were diligently following advice of congressional leaders that we needed to gain sufficient support from the derivatives industry to ensure passage of much needed reform legislation. We proposed a five-part plan:

- Convert the CFTC to an oversight agency
- Reform the artificial competitive constraints imposed by the Shad/Johnson Accord
- Expand access to futures markets
- Provide legal certainty to OTC markets
- Level the regulatory playing field

Since that testimony, most of the participants and regulators in the financial services industry have worked in good faith to find a compromise proposal. The President's Working Group on Financial Markets issued an extensive report. On February 28, 2000, the Department of the Treasury submitted a draft amendment to the Commodity Exchange Act that embodies the recommendations of the PWG.

Chairman Ewing held extensive hearings, listened to all views and concluded that the time is ripe to alleviate the excessive regulatory burdens that have greatly disadvantaged U.S. futures exchanges in comparison to their global competition. Chairman Ewing sought a consensus-driven solution that balanced the interests of all participants in the financial services industry.

This intensive effort by Chairman Ewing and the staff of his Subcommittee produced the bill that is the subject of today's hearing. We are on record praising H.R. 4541 as providing a significant reform of financial services regulation and creating a more equitable regulatory environment for futures exchanges. By providing a comprehensive approach to the inter-related goals of modernizing exchange regulation, reforming Shad-Johnson and establishing legal certainty for the OTC mar-

ket, this bill appropriately balances the interests of all participants in the financial services industry while promoting the public interest.

We strongly support Chairman Ewing's proposal to reform the Shad/Johnson Accord. Eighteen years ago, the Shad-Johnson Accord resolved a jurisdictional conflict between the SEC and the CFTC. It included a temporary ban on most equity futures contracts. It was not intended as a permanent barrier to innovation and growth. Futures exchanges were able to develop broad based stock index futures under Shad/Johnson. Those products have matured into vital financial management tools that enable pension funds, investment companies and others to manage their risk of adverse stock price movements.

The CME's long standing goal is freedom to list and trade futures contracts now forbidden by the Shad/Johnson Accord without being subjected to multiple regulators and without changing the principles upon which futures trading has been conducted for more than 100 years. Remember, we created a tremendously useful product, equity indexes, in the face of overwhelming opposition. The SEC and its exchanges opposed futures on indexes with all of the same arguments that they now raise against futures on individual securities. Nonetheless, equity indexes are among the most popular contracts on securities exchanges as well as futures exchanges. Futures trading of equity indexes has enhanced customer opportunity with none of the ill consequences predicted by the SEC or securities exchanges. In fact, their business has directly benefited.

The options markets and swaps dealers offer customers risk management tools and investment alternatives involving both sector indexes and single stock derivatives. Futures exchanges have been frozen out. Shad/Johnson's "temporary" ban lasted 18 years during which time single stock futures have thrived in the OTC market in the form of equity swaps and on option exchanges in the form of synthetic futures. Recently the President's Working Group, the General Accounting Office and congressional leaders have all called for an end to the ban.

On December 17, 1999, Chairman Lugar (Senate Agriculture Committee) and Chairman Gramm (Senate Banking Committee) asked CFTC Chairmen Rainer and SEC Chairman Levitt for a "detailed report addressing the desirability of lifting the current prohibition on single stock futures together with any legislative proposals...no later than February 21, 2000." On January 20, 2000, Commerce Committee Chairman Bliley along with Chairmen Combest and Ewing asked the SEC and CFTC to create a "joint legislative plan for repealing the current prohibition on single stock futures...no later than February 21, 2000." On March 2d, Chairmen Levitt and Rainer responded by presenting "the current views" of the agencies, but failed to offer a specific legislative plan.

Of course, we are pleased that the CFTC and SEC have agreed that it is appropriate that U.S. exchanges be permitted to compete in world markets and offer U.S. customers the opportunity to manage risks by means of equity futures contracts. We are also pleased that they have found a way to accommodate their jurisdictional and regulatory concerns on several important issues. But it is far too late in the game to be satisfied with signs of progress. We share Senator Lugar's "disappointment" that the agencies were unable to resolve all of their jurisdictional concerns within the time frame requested.

Today, Shad-Johnson is a bar to useful competition. The SEC invoked Shad-Johnson to bar futures on the Dow Jones Utilities and Transportation Averages—because that index did not "reflect" the utilities and transportation sectors. The United States Court of Appeals overturned and vacated that SEC decision, *Board of Trade v. Securities and Exchange Commission*, No. 98-2923 (7th Cir., August 10, 1999). The court of appeals found: "The stock exchanges prefer less competition; but if competition breaks out they prefer to trade the instruments themselves...The Securities and Exchange Commission, which regulates stock markets, has sided with its clients." Slip Op. at 4.

Congress intended the Shad-Johnson ban on single stock futures to be temporary. The court of appeals found that the ban "was a political compromise; no one has suggested an economic rationale for the distinction." Slip Op. at 4. In the absence of such a rationale, Congress should lift the single stock futures ban and allow the marketplace to decide whether these instruments would be useful new risk management tools. Many exchanges around the world trade single stock futures; no reason exists to deny U.S. customers and markets the same opportunity.

H.R. 4541 will enact an appropriate division of responsibility between the SEC and CFTC for futures trading of contracts currently prohibited by the Shad/Johnson Accord. It protects the SEC's enforcement authority and forecloses avoidance of securities act proscriptions by means of futures contracts. It protects options exchanges from regulatory arbitrage arising out of disparate margin treatment. It serves the public interest in fair competition and access to new products. It imposes

more restrictions on futures exchanges than we had hoped for but not so many that we will be unable to fairly test the market's appetite for new products

Last year, the 106th Congress took dramatic action and modernized regulation of most financial services firms by adopting the Gramm-Leach-Bliley Act. The consequences of excluding the derivatives industry from this progressive groundswell would be disastrous. We hope that Congress will act expeditiously on H.R. 4541 to ensure that complete financial regulatory reform becomes part of the legacy of this Congressional Session. We pledge to work diligently with members of the House to ensure that the all of the fundamental principles of this bill are enacted into law this year.

Thank you again, Mr. Chairman, for the opportunity to include our written testimony in the record of this hearing.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
WASHINGTON, DC
July 12, 2000

DAVID CAVICKE, *Majority Counsel*
2125 RHOB
Washington, DC 20515

DEAR MR. CAVICKE: The North American Securities Administrators Association (NASAA)¹ appreciates the opportunity to provide comments on H.R. 4541, the Commodity Futures Modernization Act of 2000. We support your effort to modernize our futures laws and provide legal certainty for over-the-counter derivatives.

NASAA also supports lifting the Shad-Johnson ban on single stock futures once the regulatory oversight concerns underlying the ban are addressed. Any regulatory framework must recognize the expertise of both the SEC and the CFTC in regulating these products and the unique enforcement role played by the 20-plus states that have adopted the Model Commodity Code. Both federal agencies and state securities agencies must have the authority to carry out their core functions; there should be no barriers in their efforts to curtail fraud and manipulation.

In 1974, Congress preempted state securities agencies from applying their laws, including enforcement, to persons and transactions within the Jurisdiction of the Commodity Exchange Act (CEA). Not long after, there was a proliferation of off-exchange commodities fraud. In 1978, Congress passed Section 6(d) of the CEA to provide the states with the authority to enforce state laws of general criminal application and allowed the states to enforce the CEA in federal court.

It would be unwise at this time to move ahead with legislation that lacks the elements necessary to ensure the market integrity and customer protections that investors have come to expect under the securities laws.

It is important to recognize that single stock futures will be a substitute for stocks and stock options and be sold as a retail product. While complex derivatives are sold mostly to institutional customers, futures on a single stock are the type of product that will be attractive to the retail investing public. Single stock futures must be offered to retail investors with the same protections afforded to those who now buy stocks and stock options. Americans are investing in our capital markets in record numbers due largely to confidence in the markets instilled by our complementary Federal/state/industry system of regulation.

Any legislation to lift the current ban on single stock futures must maintain the SEC's ability to protect investors and to maintain integrity of the markets on which they trade. The SEC should have clear and direct authority over the markets and market participants trading single stock futures.

SEC and CFTC Chairmen Arthur Levitt and Bill Rainer have made considerable progress toward reaching agreement on a regulatory regime for single stock futures. They should be given sufficient time to finalize the details of a plan to share regulation of single stock futures so each agency can utilize its expertise and create a framework that allows for effective and efficient joint regulation of these products.

NASAA appreciates the efforts of your Subcommittee to consider H.R. 4541 under a limited time frame. We urge you to amend the current version of the legislation and extend the protections of the securities laws to single stock and narrow-based stock index futures. American investors deserve no less.

¹The oldest international organization devoted to investor protection, NASAA was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for investor protection and efficient capital formation.

Please do not hesitate to contact me at 317-232-6695 or Deborah Fischione, NASAA's Director of Policy, at 202-737-0900.

Sincerely,

BRADLEY W. SKOLNIK
Indiana Securities Commissioner
NASAA President

PREPARED STATEMENT OF THE BOND MARKET ASSOCIATION

The Bond Market Association is pleased to comment on H.R. 4541, the Commodity Futures Modernization Act of 2000. H.R. 4541 represents an important step in the regulatory reform of the markets for derivative financial products. The bill includes a number of proposals designed to streamline the regulatory environment for derivatives, and clarify several important areas of legal uncertainty which result in undue systemic risk. For these reasons, we commend Chairman Oxley for focusing the subcommittee's attention on H.R. 4541 and we support these aspects of the bill.

Reauthorization of the Commodity Exchange Act (CEA) presents an opportunity to clarify the regulation of certain financial products and to eliminate any misconception regarding the scope of authority provided under the CEA. We concur with the widely held belief that swaps are inappropriately regulated as futures, and we believe that the CEA should codify the principle that swaps should not be regulated as futures by the Commodity Futures Trading Commission (CFTC). Such clarification would mitigate legal risk for market participants and would help maintain over-the-counter markets as viable alternatives to traditional, organized exchanges. It would also help avoid duplicative and unnecessary regulation. Congress has the opportunity through the CEA reauthorization to help assure that the capital markets can continue to operate as efficiently as possible.

The Bond Market Association represents securities firms and banks that underwrite, trade and sell fixed-income securities in the U.S. and international markets. Our interests in H.R. 4541 relate to how the bill would affect the efficient operation and regulation of the markets for bonds and other fixed-income securities and related instruments, and our comments will focus on just those aspects of the bill.

The Financial Markets and the CEA

As the Subcommittee is aware, the financial markets have grown increasingly complex in recent years. Issuers of securities and other market participants have become accustomed to having a wide array of products available to meet very specific financing and hedging needs. Unfortunately, the United States regulatory system has not kept pace with the evolution of the marketplace. Issuers, underwriters and dealers now find themselves laboring to decipher a web of overlapping and often contradictory statutes and regulations that reduce efficiency and increase costs. Of particular concern is the potential for private parties to exploit ambiguities in the CEA to abandon responsibility for otherwise enforceable contracts—even if there is no fraud or bad faith—by alleging that a transaction is an illegal off-exchange futures transaction. We know that this subcommittee, regulators and participants in these markets have an interest in ensuring the finality of financial contracts and thereby reducing potential risks to the financial system as a whole, and we commend Chairman Oxley for exploring ways to improve and update the Commodity Exchange Act.

The Association takes an active interest in promoting and ensuring safe and efficient bond markets that allow governmental entities and corporations to raise debt capital at the lowest possible cost. Toward that end, the basic policy positions we seek to advance as Congress and the regulatory agencies deal with issues surrounding the CEA are:

- preserving the finality and enforceability of contracts freely negotiated between market participants;
- maintaining the OTC markets as a viable alternative to traditional organized exchanges; and
- avoiding duplicative or unnecessary government regulation in the trading and clearance of debt instruments.

Consistent with the above principles, we offer the following summary of our views on certain issues that are integral to the current discussion of CEA reauthorization. The Association:

- supports provisions of the bill which would reaffirm and clarify the Treasury Amendment and recommends an additional change;
- supports the goals of other provisions of H.R. 4541 designed to provide "legal certainty" for over-the-counter derivatives; and

- supports provisions of the bill related to derivatives clearing organizations;
- urges the adoption of legislation to reduce systemic risk in the financial markets by reforming bankruptcy and insolvency law to clarify and enhance the ability to close-out and net financial contracts.

Treasury Amendment

The market for government securities is well regulated under a structure tailored to the unique qualities of the market. Under authority provided by the Government Securities Act of 1986 and subsequent 1993 amendments, the Treasury Department is a principal rulemaker for the government securities market. The Treasury Department, in consultation with other regulators, has published detailed rules regarding large position reporting and record-keeping. The National Association of Securities Dealers and bank regulators have published rules regarding sales practices. The SEC has broad authority to enforce antifraud statutes on government securities market participants. The CFTC and the organized exchanges, of course, regulate activity related to transactions in listed futures contracts on government securities. This balanced arrangement ensures that the government securities market remains safe and well-regulated in addition to serving as a model of market efficiency.

Efficient and sound regulation of the government securities market is important because it helps ensure that taxpayers pay the lowest possible interest cost on the government's borrowing and that other U.S. borrowers whose debt is priced relative to Treasury securities—corporations, financial institutions, homebuyers, consumers and others—also enjoy efficiently determined borrowing costs. There are approximately \$3.1 trillion of marketable Treasury securities outstanding, and over \$200 billion of Treasury securities change hands every day. Any undue risk or uncertainty regarding the market's regulatory structure can have significant effects on the government's interest cost and the interest rates faced by other borrowers.

When the CEA was first enacted in 1974, Congress included a provision precluding the CFTC from regulating “transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.” This provision has become known as “the Treasury Amendment.” The Treasury Amendment is important because it helps prevent duplicative or conflicting regulation.

Despite the plain meaning of existing statutory language, the Treasury Amendment does not *explicitly* address questions regarding the regulation of financial products which involve government securities. These include, for example, instruments such as repurchase agreements, swap contracts and forward delivery contracts. This issue was addressed, albeit indirectly, by the U.S. Supreme Court in its 1997 decision in *Dunn v. CFTC*, where the Court generally held that “transactions in” foreign currency encompass all transactions relating to foreign currency. Market participants nevertheless widely believe that the same standard applies to other financial products covered under the Treasury Amendment, including government securities.

H.R. 4541 would generally maintain the current structure of the Treasury Amendment. The bill would specify that the CEA does not apply to transactions *in* government securities, foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase transactions in a financial commodity—a particularly important and welcome clarification—or mortgages or mortgage purchase commitments. Futures contracts related to these products traded on an “organized exchange” would still be subject to CFTC regulation under the bill. The bill retains existing statutory language, implying Congress’ intent to embrace the Supreme Court’s interpretation of such language. However, H.R. 4541 would not expressly codify the Supreme Court’s interpretation of existing law regarding financial products involving the enumerated instruments. We, therefore, suggest amending H.R. 4541 to fully clarify the scope of the Treasury Amendment provisions and address any remaining legal uncertainty regarding the scope of the Treasury Amendment’s applicability. In particular, we suggest adding language to Section 4 of the bill specifying that the Treasury amendment exclusions apply to transactions “in or in any way involving” the specified instruments.

Organized Exchanges

H.R. 4541 would also clarify the applicability of the Treasury Amendment by specifying an exception to the general exclusion for contracts traded on an “organized exchange.” Current law provides an exception to the Treasury Amendment for contracts traded on a “board of trade.” The definition of “board of trade” is somewhat vague with respect to both evolving electronic trading systems and the roles

of certain traditional market participants such as inter-dealer brokers. If “board of trade” was defined under current law to include electronic trading facilities or situations where market participants conduct transactions in a screen-based format and settle them through an independent clearing mechanism, significant market disruption would result. In particular, such a definition would subject already regulated markets to a duplicative layer of government regulation.

We support the clarification of the Treasury Amendment exclusion from the CEA through the “organized exchange” exception. The bill as introduced, however, included a vague definition of organized exchange that would have required that transactions take place on a “*bona fide* principal-to-principal basis,” calling into question the applicability of the exception to traditional “back-to-back” principal transactions. The Agriculture Committee during its deliberations on H.R. 4541 clarified the definition of organized exchange by eliminating the confusing term “*bona fide*.” We strongly support this change and we urge that it be retained in the legislation.

Legal Certainty for OTC Derivatives

Under current law, the CEA effectively gives a party the right to rescind a contract if the party is successful in its allegations that the transaction was actually an illegal, off-exchange futures contract. Under the CEA, over-the-counter commodity futures transactions are *per se* illegal unless they are excluded by the Treasury Amendment or some other exclusion or exemption. Private parties have taken the position that such transactions are subject to rescission. This harsh consequence of voiding a contract is particularly troublesome in light of the difficult questions associated with defining a future versus a forward transaction. We believe the financial markets should not be subject to the risks posed by the ability to abandon contract obligations when the CEA status of a financial transaction is challenged. H.R. 4541 includes two key provisions designed to address this problem.

First, the bill would specify that financial contracts may not be rescinded “solely on the failure of the agreement, contract, or transaction to comply with the terms or conditions of an exemption or exclusion from any provision of this Act or regulations of the Commission.” Second, the bill would specify that the CEA does not apply to over-the-counter derivative contracts entered into between “eligible contract participants” which are not conducted on a “trading facility” other than an “electronic trading facility.” Together, these two provisions represent a major step towards addressing the question of the “legal certainty” of over-the-counter derivative contracts, a goal which we fully support.

Clearing Organizations

The process of clearing securities and derivatives transactions is vital to the efficient operation of the capital markets. Efficient clearing reduces risks and costs and makes possible the smooth operation of the markets. Following a transaction, both parties submit the details of the transaction to a clearing organization. The clearing organization compares the transaction—ensures that details submitted by both parties are identical—and, once compared, usually guarantees the transaction in the unlikely event that one party becomes insolvent before the transaction settles. Clearing organizations also net outstanding transactions of individual participants in order to minimize separate payments for offsetting trades or positions, and monitor margins or collateral required to be held against net positions.

H.R. 4541 includes a provision designed to streamline the regulation of derivatives clearing organizations. Specifically, Section 14 of the bill would generally make it unlawful for derivatives clearing organizations to operate unless registered with the CFTC. In order to prevent duplicative levels of regulation, the bill provides an exemption from this requirement for clearing organizations which are regulated by the SEC, a federal bank regulator or a foreign regulatory body. This exemption is critical in helping to ensure that clearing organizations are not subject to superfluous, conflicting, multiple levels of regulation. For this reason, we support the exemption.

The bill as introduced contained a provision which would have mandated CFTC regulation for clearing organizations which clear futures, options on futures or options on commodities which are not securities regardless of the above exception. However, during its deliberations, the House Agriculture Committee included an exemption from this requirement for clearing organizations that clear instruments or transactions which are generally exempted from regulation under the CEA. The change adopted by the Agriculture Committee to Section 14 of the bill is extremely important in ensuring that clearing organizations that clear both securities and over-the-counter derivatives are not subject to multiple levels of regulation. We fully

support the Agriculture Committee's changes, and we are hopeful that the committee's changes will remain in the bill.

Other Provisions of H.R. 4541

In addition to the provisions cited above, The Bond Market Association offers these comments on other provisions of H.R. 4541:

- **Shad-Johnson accord**—Although presumably intended to permit single-stock futures, the bill expressly would allow futures on “non-exempt securities,” thereby permitting futures on single debt instruments or on narrow debt indices. Key aspects of the Shad-Johnson provisions in H.R. 4541 have apparently been drafted to apply specifically to stock futures and in some cases are inconsistent with the way the debt markets operate. They could result in confusion and uncertainty if applied to futures on single debt instruments. The subcommittee may wish to review the Shad-Johnson provisions of the bill to ensure their consistency with debt market operations and with other provisions of the law. We would be happy to consult with subcommittee members on this issue if requested.
- **Bankruptcy**—Although not part of H.R. 4541, the report of the President's Working Group on the Financial Markets on financial derivatives recommended the adoption of changes to the Bankruptcy Code and banking law designed to reduce systemic risk. The Working Group's recommendations would streamline the process by which financial contracts can be netted and resolved in cases of bankruptcy or insolvency. We support these provisions and urge that they be enacted.

Summary

In recent years, we have seen a rapid acceleration in the development of new and sophisticated financial products designed to mitigate risk, reduce costs and enhance efficiency. Unfortunately, the evolution of our regulatory structure for financial derivatives has lagged behind the evolution of the markets themselves. It is appropriate, therefore, for Congress to address the uncertainty and risk which has arisen as a result of a system of regulation which never anticipated the market we have today.

The Bond Market Association supports provisions in H.R. 4541 designed to enhance and clarify the Treasury Amendment. We also recommend an additional change to the Treasury Amendment to clarify the treatment of products involving excluded transactions. We also support the goal of key provisions of the bill to provide legal certainty with respect to the regulation of over-the-counter derivatives. In addition, we support provisions in the bill adopted during Agriculture Committee deliberations designed to prevent the duplicative regulation of clearing organizations. We raise questions regarding the application of the Shad-Johnson provisions to single-debt futures, and we urge the adoption of bankruptcy and insolvency legislation designed to reduce systemic risk in the financial markets.

We appreciate the opportunity to present our views on H.R. 4541. We commend Chairman Oxley and other members of the subcommittee for their quick action on these important issues, and we look forward to working with subcommittee members and staff as the legislative process moves forward.

FEDERAL RESERVE SYSTEM
BOARD OF GOVERNORS
July 19, 2000

The Honorable TOM BLILEY
Chairman
Committee on Commerce
House of Representatives
Washington, D.C. 20515

DEAR MR. CHAIRMAN: Enclosed are my responses to your additional questions concerning H.R. 4541, the Commodity Futures Modernization Act of 2000.

Please let me know if I can be of further assistance.

Sincerely,

PATRICK M. PARKINSON
Associate Director, Division of Research and Statistics

Enclosure

FOLLOW-UP QUESTIONS FOR PATRICK M. PARKINSON

Question 1. I Would an alternative approach to providing legal certainty under which futures were defined as contracts on enumerated agricultural products and any other derivatives product traded on a futures contract market provide greater legal certainty than the approach in H.R. 4541? Would the Fed support such an approach?

Answer 1. Yes. Such an approach would provide greater legal certainty. But the approach would need to be supplemented with provisions to address public policy concerns about fraud and manipulation for those transactions that would be excluded from the CEA under this alternative approach but not under the working group's approach. Whether the Fed would support such an alternative approach would depend on how those concerns are addressed.

Question 2. Do the margin provisions in the bill adequately address concerns about consistent margins on single stock futures and options?

Answer 2. Yes. They empower the Federal Reserve to ensure that margins are consistent and make clear what is meant by consistency. However, the language clarifying what is meant by consistency should be moved from Section 8(g)(7)(D)(ii) to Section 8(g)(4)(B)(v).

Question 3. Futures trading on a futures exchange could be regulated in one of two ways: (1) as securities with SEC exemptions from non-core provisions or (2) as futures with only core securities provisions applying. Which structure does the Fed support?

Answer 3. The Federal Reserve does not have a position on this issue.

Question 4. Do you support the creation of the intermarket margin board as provided in the bill?

Answer 4. Yes. As I said in my testimony, the Board is willing to accept regulatory authority over levels of margin on single-stock futures, so long as the Board can delegate that authority to the CFTC, the SEC, or an Intermarket Margin Board.

Question 5. Do you support enacting the legal certainty portions of the bill without removing the ban on single stock futures? Under this scenario will legal uncertainty still exist for OTC derivatives in securities based transactions.

Answer 5. Yes. We support enacting the legal certainty provisions of the bill, even if the ban on single-stock futures is not removed. We would, however, prefer a comprehensive bill that allows U.S. investors to trade single-stock futures.

Under this scenario, legal certainty would still exist with respect to the enforceability of securities-based swaps between eligible participants. However, legal uncertainty would still exist on the question of whether securities-based swaps are subject to the securities laws.

Question 6. Do the clearing provisions in the bill place futures clearing systems at a competitive disadvantage to securities clearing systems?

Answer 6. Yes. An SEC registered clearing organization could clear both securities and securities-based derivatives, whereas a CFTC-registered clearing organization could not. As a practical matter, this would allow an SEC clearing organization to offer lower margins on securities-based derivatives when those positions were hedged with securities, as they often are. Other things equal, this would place CFTC-registered clearing systems at a competitive disadvantage.

Question 7. Are futures exchange's "know your customer rules" and "risk acknowledgment" sufficient substitutions for suitability rules?

Answer 7. I have not studied these rules closely enough to permit me to answer this question with any confidence.

Question 8. To what extent, if any, does the CFTC's regulatory relief proposal reduce the need for legislation?

Answer 8. The CFTC's regulatory relief proposal is no substitute for legislation. It does not address the most serious legal certainty issue—the enforceability of securities-based swaps.

Question 9. The Working Group report concludes that electronic trading systems should be permitted to develop unburdened by an anticipatory regulatory framework? How does H.R. 4541 achieve, or fail to achieve, this result?

Answer 9. H.R. 4541 achieves this for electronic trading systems for financial derivatives. For non-financial derivatives (other than derivatives based on agricultural commodities and metals), it leaves some burdens (statutory prohibitions of fraud and manipulation, possibly CFTC rules and regulations relating to data dissemination) but frees such systems from the kinds of burdens that would most concern the PWG and market participants. For electronic trading systems for agricultural and metals derivatives, achievement of a result consistent with the Working Group's conclusion would depend on CFTC regulatory exemptions for such systems.

DEPARTMENT OF THE TREASURY
August 8, 2000

The Honorable THOMAS J. BLILEY
Chairman, Committee on Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

DEAR CHAIRMAN BLILEY: I am pleased to enclose responses to your questions submitted following the July 11, 2000 hearing held by the Subcommittee on Finance and Hazardous Waste on H.R. 4541, "The Commodity Futures Modernization Act of 2000."

Question 1: In your testimony you state that certain aspects of the regulatory relief may be more appropriately addressed through rule making than legislation. With which provisions of the bill are you particularly concerned?

Answer 1: The Treasury Department continues to support the view that it is appropriate to periodically review existing regulatory structures to determine whether they continue to serve valid public policy and regulatory functions. We are concerned, however, that there may be unforeseen consequences to legislating such regulatory relief as is contained in sections 12, 13, 14, 15, 16, 17, and 21 of H.R. 4541. Once codified, regulators will no longer have the flexibility to review and amend provisions when market developments necessitate change or problems arise. Such aspects of regulatory relief may be more appropriately provided through administrative action. However, if Congress legislates regulatory relief, it is important that the language is drafted carefully to ensure that futures on government securities are not excluded from most of the provisions of the CEA that currently apply, as well as from regulation under the securities laws, in a manner that would undermine the regulatory framework for the government securities market established by the Government Securities Act in 1986.

Question 2: Do you support the creation of the intermarket margin board as provided in the bill?

Answer 2: The Treasury Department generally supports the provisions in section 8 of H.R. 4541 to create an intermarket margin board, comprised of the Board of Governors of the Federal Reserve System ("Fed"), Securities and Exchange Commission ("SEC"), and Commodity Futures Trading Commission ("CFTC"), to set and maintain margin levels for single stock and narrow-based stock index futures. We concur that such a board should endeavor to harmonize margin levels on single stock futures and options, taking into consideration material differences in contract size, price volatility, mark-to-market frequency, and the period of time within which margin calls must be met. This provision should not supersede or limit the emergency powers of the CFTC contained in §8a(9) of the Commodity Exchange Act ("CEA") regarding establishment of temporary emergency margin levels.

Question 3: Do you support enacting the legal certainty portions of the bill without removing the ban on single stock futures? Under this scenario will legal uncertainty still exist for OTC derivatives in security-based transactions?

Answer 3: The Working Group report recommended that legal certainty for swap transactions be provided and that the prohibition against single stock futures could be repealed if integrity and regulatory arbitrage issues could be resolved. However, the recommendations were not contingent upon each other. The Treasury Department has been working diligently with the CFTC and SEC to resolve issues related to the Shad-Johnson Accord prohibition against single stock futures. We support enacting the legal certainty portions of the legislation as soon as possible. Failure to clarify and resolve the legal certainty issue could result in a situation which the existing legal framework for U.S. financial markets significantly lags developments and innovations in those markets.

If issues related to the Shad-Johnson Accord cannot be resolved on a timely basis, we believe it is imperative to advance the other provisions of H.R. 4541 designed to clarify legal certainty for OTC derivatives, provide for the development of appropriately-regulated clearinghouses, and protect retail customers from fraud and abuse in foreign exchange futures and futures-options transactions with unregulated/unaffiliated entities.

With respect to legal certainty for securities-based OTC derivatives, because the legal certainty provisions of H.R. 4541, as reported by the House Agriculture Committee, would exclude such derivatives from the CEA, these provisions would eliminate the concern about their enforceability that exists under current law. The legal certainty provided to these instruments by sections 4, 5, 6, and 7 of H.R. 4541 is not dependent upon the removal of the ban on exchange-traded futures on single securities or narrow indexes.

Question 4: Do the clearing provisions in the bill place futures clearing systems at a competitive disadvantage to securities clearing systems?

Answer 4: The Treasury Department believes that the clearing provisions in section 14 of the bill will create a level playing field for clearing systems. Futures clearing organizations will be able to clear exchange-traded futures, futures-options, and commodity options as well as non-security OTC derivative instruments. Securities clearing organizations will be able to clear exchange-traded and OTC securities transactions as well as OTC derivatives.

Question 5: Are futures exchanges' "know-your-customer rules" and "risk acknowledgements" sufficient substitutions for suitability rules?

Answer 5: The CFTC and SEC currently are discussing customer suitability requirements for securities futures in the context of modifications to the Shad-Johnson Accord. The Treasury Department feels that it is appropriate that the CFTC and SEC should discuss and agree to the approach and specific requirements ultimately mandated with respect to these instruments. The Working Group stated that the current prohibition against single stock and narrow-based stock index futures could be repealed if such issues regarding the integrity of the underlying securities markets and regulatory arbitrage could be resolved, but preferred that the CFTC and SEC reach a mutually acceptable resolution. We recently have assumed a role in these discussions as a facilitator between the two agencies, and we support actions taken by Congress to urge progress in these discussions.

Question 6: To what extent, if any, does the CFTC's regulatory relief proposal reduce the need for legislation?

Answer 6: The Treasury Department believes that it is imperative to provide for legal certainty for OTC derivatives through legislation. The CFTC proposal to grant regulatory relief to the futures exchanges does not reduce the need for the other provisions of the bill to clarify legal certainty for OTC derivatives, provide for the development of appropriately-regulated clearinghouses, and protect retail customers from fraud and abuse in foreign exchange futures and futures-options transactions with unregulated unaffiliated entities.

Question 7: The Working Group report concluded that electronic trading systems should be permitted to develop unburdened by an anticipatory, regulatory framework. How does H.R. 4541 achieve, or fail to achieve, this result?

Answer 7: The Working Group recommended a broad exclusion from the CEA for electronic trading systems ("ETs") that limit trading to eligible participants trading on a principal-to-principal basis involving OTC financial commodities with non-finite supplies. The group felt that development of such systems should be encouraged by providing greater legal certainty, rather than burdening markets with a new anticipatory scheme of regulation that could inhibit innovation and prove to be inappropriate. Section 6 of H.R. 4541 amends the CEA to permit such ETs consistent with the Working Group's recommendations.

I hope this information is helpful to you and your staff. Please feel free to contact me if I can be of further assistance. We look forward to continuing to work with you.

Sincerely,

LEE SACHS
Assistant Secretary, Financial Markets